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## Systemic Stewardship with Tradeoffs<sup>1</sup>

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### Abstract

“Universal owners” – asset managers and owners that hold a significant swath of many public companies -- have become important forces in the capital markets. As a group, they hold a significant percentage of the shares of public companies, often with substantial holdings in individual portfolio firms. Some commentators have argued that universal owners should use their influence in portfolio companies to maximize the value of the overall portfolio, rather than the value of any particular company. For some, this means that universal owners should adopt “systemic stewardship” that would push for market wide initiatives to reduce environmental externalities and control systemic risk (e.g., standardized climate risk disclosure, board diversity targets, etc.). Others push for a more ambitious agenda in which universal owners would take affirmative steps to mitigate risks to the long term value of the portfolio such as the risk of climate change by, for example, pushing carbon emitters to cut output, whether or not that promotes firm value.

But shareholders, even universal owners, do not manage companies. Rather, the business and affairs of a corporation are managed by full time senior management teams under the general oversight of a board of directors, within a framework created by corporate law. In this article, we analyze the extent to which universal owners can and should be expected to sacrifice single firm value even when doing so increases the value of the overall portfolio. We are quite pessimistic about the potential of systemic stewardship that entails substantial tradeoffs among portfolio companies.

This is for three principal reasons. First, universal owners would have to take into account the possibility that inducing some firms to reduce environmental externalities and mitigate risk will generate a competitive response that will eliminate the benefits from these actions for their other portfolio companies. If that were to happen, universal owners would be stuck with the losses without receiving any corresponding gains. Second, corporate law, as it currently stands, has a strong “single firm focus” (“SFF”) that stands in sharp contrast to the potential “multi-firm focus” (“MFF”) of large portfolio investors. If universal owners were to work individually or together to protect their overall portfolios from systemic risk, it would clash with corporate law, securities regulation and potentially antitrust in a fundamental way that could create significant risks of liability and a significant potential for political backlash. Third, universal owners typically manage a wide variety of different portfolios for different clients each of whom is owed fiduciary duties. A “trade-off” strategy that would benefit some portfolios at the expense of other portfolios would conflict with these fiduciary duties as well as with the core multi-client multi-portfolio business model. As a result, we expect that universal owners will act unilaterally and under cloak of promoting single firm value, but by doing so will not be very effective in promoting portfolio value.

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<sup>1</sup> Thanks to John Galloway, Zohar Goshen, Matt Mallow etc and participants in the INSERT for helpful comments and criticisms.

## Introduction

If you manage a “universal owner” – an asset owner or manager that holds a wide swath of public companies – should you look at each of your portfolio companies separately, and ask what is best for that company, or should you take a portfolio-wide approach? Should you focus your efforts on controlling systemic risk that can doom your whole portfolio (and the world) rather than firm-specific “idiosyncratic” risks that are already mitigated by wide diversification?<sup>2</sup> Should you care if one company’s actions have adverse effects on other companies that you own? And if you, and other universal owners, collectively hold enough stock to exert substantial influence, should you use that influence to reduce negative externalities and systemic risk for the whole portfolio (and society) even at a cost to individual portfolio companies? Is it possible to do the first without also trying to do the second?

“Universal owners” have become important forces in the capital markets. They collectively hold a significant percentage of the shares of public companies, often with substantial holdings in individual portfolio firms.<sup>3</sup> They have become the focus of much attention. Some commentators have argued that universal owners should use their influence in portfolio companies to maximize the value of the overall portfolio, rather than the value of any particular company.<sup>4</sup> For some, this means that universal owners should adopt “systemic stewardship” that would push for market wide initiatives to control systemic risk (e.g., standardized climate risk disclosure, board diversity targets, etc.).<sup>5</sup> Others push for a more ambitious agenda in which universal owners would take affirmative steps to mitigate risks to the long

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<sup>2</sup> Jan Fichtner and Eelke Heemsker, The New Permanent Universal Owners, 49 *Economy and Society* 493, 495 (2020) (“We thus call BlackRock, Vanguard and State Street the ‘New Permanent Universal Owners’ as they are invested indefinitely in thousands of firms that are members of international stock indexes; they only divest when the composition of an index changes.”) See, also, James Hawley and Andrew Williams, The Emergence of Universal Owners, 43 *Challenge* 43 (2000); PRI, Universal Ownership: Why environmental externalities matter to institutional investors, [https://www.unepfi.org/fileadmin/documents/universal\\_ownership\\_full.pdf](https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf) (“Large institutional investors are, in effect, “Universal Owners”, as they often have highly-diversified and long-term portfolios that are representative of global capital markets.”). Kiernan, Matthew J., Universal Owners and ESG: Leaving Money on the Table?, *Corporate Governance: An International Review*, Vol. 15, No. 3, pp. 478-485, May 2007, Available at SSRN: <https://ssrn.com/abstract=984340> or <http://dx.doi.org/10.1111/j.1467-8683.2007.00580>.

As will be discussed in more detail below, what commentators refer to as “universal owners” – the large asset managers and owners who invest in many or most public companies – are, in fact, not really universal owners.

<sup>3</sup> Summarize current data.

<sup>4</sup> Rick Alexander; Jeff Gordon, Systemic Stewardship, ; Madison Condon; Majority Action, Climate in the Boardroom: How Asset Manager Voting Shaped Corporate Climate Action in 2019 <https://www.majorityaction.us/asset-manager-report#:~:text=In%202019%2C%20the%20world's%20largest,climate%20and%20their%20irresponsible%20lobbying> ; Trucost, Universal Ownership: Why environmental externalities matter to institutional investors (2011), [https://www.unepfi.org/fileadmin/documents/universal\\_ownership\\_full.pdf](https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf).

<sup>5</sup> Jeffrey N., Systematic Stewardship (February 14, 2021). Columbia Law and Economics Working Paper No. 640, European Corporate Governance Institute - Law Working Paper No. 566/2021, Available at SSRN: <https://ssrn.com/abstract=3782814> or <http://dx.doi.org/10.2139/ssrn.3782814>

term value of the portfolio such as the risk of climate change by, for example, pushing carbon emitters to cut output, whether or not that promotes firm value.<sup>6</sup>

But shareholders, even universal owners, do not manage companies. Rather, the business and affairs of a corporation are managed by full time senior management teams under the general oversight of a board of directors, within a framework created by corporate law. In this article, we analyze the extent to which universal owners can and should be expected to sacrifice single firm value even when doing so increases the value of the overall portfolio. We are quite pessimistic about the potential of systemic stewardship that entails substantial tradeoffs among portfolio companies.

This is for three reasons. First, universal owners would have to take into account the possibility that inducing some firms to mitigate risk will generate a competitive response that will eliminate the benefits from risk mitigation for their other portfolio companies. If that were to happen, universal owners would be stuck with the losses without receiving any corresponding gains. Second, corporate law, as it currently exists, has a strong “single firm focus” (“SFF”) that stands in sharp contrast to the potential “multi-firm focus” (“MFF”) of large portfolio investors. If universal owners were to work individually or together to protect their overall portfolios from systemic risk, it would clash with corporate law, securities regulation and potentially antitrust in a fundamental way that could create risks of liability and a significant potential for political backlash. Third, universal owners that are asset managers (e.g., BlackRock and Vanguard) typically manage a wide variety of different portfolios for different clients each of whom is owed fiduciary duties. A “trade-off” strategy that would benefit some portfolios at the expense of other portfolios would conflict with these fiduciary duties as well as with the core multi-client multi-portfolio business model. Similarly, universal owners that own assets (e.g., CalPERS) typically hold those assets in different segregated funds for different sets of beneficiaries and utilizing a variety of investing strategies over a variety of asset classes. A “trade-off” strategy that would advantage some funds or strategies at the expense of others would raise both legal and political issues. As a result, we expect that universal owners will act unilaterally and under cloak of promoting single firm value, but by doing so will not be very effective in promoting portfolio value.

## **I. The Potential Benefits of “Systemic Stewardship”**

### **a. Universal Owners and Externalities**

Universal owners – the large asset owners and managers with market-wide portfolios – are larger than ever. It is often the case that the largest asset owners and managers such as BlackRock, BNY Mellon, CalPERS, CalSTRS, Capital Group, Fidelity, Norges Bank, State Street and Vanguard, among others -- will collectively hold more than 30% of the shares of even the largest public companies. The huge scale combined with market wide diversification of the largest universal owners means that universal owners have incentives to induce firms to internalize intra-portfolio externalities: the effects of the actions by

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<sup>6</sup> See, e.g., Madison Condon, Externalities and the Common Owner, 95 Washington L. Rev. 1 (2020); Frederick H. Alexander, The Benefit Stance: Responsible Ownership in the Twenty-First Century, 36 Oxford Review of Economic Policy 341 (2020).

one firm on the value of other portfolio holdings, including environmental (and perhaps social) externalities.<sup>7</sup>

Rick Alexander, who was instrumental in developing benefit corporations and is the founder of “The Shareholder Commons” which pushes for systemic stewardship, argues that universal owners should take seriously the cost of externalities generated by portfolio companies:

For example, because the first interest of UOs [universal owners] is in preserving healthy systems, investment fiduciaries can account for systemic costs when allocating capital or exercising control rights over it. Individual corporations that raid common resource pools or otherwise take actions that exploit social or environmental systems can be disciplined by fiduciaries representing UOs. The UO can be comfortable that if it persuades a portfolio company to act responsibly through engagement, and competitors of that company seek an advantage by continuing to act irresponsibly, the UO’s relative returns will be protected by the overlap of its ownership with that of other UOs.<sup>8</sup>

Madison Condon has sharpened this perspective by providing a plausible and concrete example.<sup>9</sup> ExxonMobil, alone, is responsible for 1.2% of annual global emissions, while Chevron is responsible for 0.8%.<sup>10</sup> Given the externalities from climate change to the rest of a market portfolio, she argues, it would make economic sense for universal owners to reduce ExxonMobil’s and Chevron’s carbon output significantly even at the cost of a lower stock price:

Consider the analysis BlackRock makes when weighing whether or not to intervene to take a measure to curtail production at two firms, Chevron and Exxon. Assume this investor intervention forces each company to reduce its emissions by 40%, and this commitment results in that company’s share price falling by 20%. . . If it loses 20% of the value of each of these assets, it will lose \$6.3 billion total. . . [B]y intervening to reduce 1% of annual industrial emissions each year, BlackRock could avoid damages to its portfolio with a net present value of \$9.7 billion. Because this value of mitigated damages outweighs the loss of share value from diminished expected fossil fuel profits by \$3.4 billion, it would be in BlackRock’s rational

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<sup>7</sup> For an early treatment of this perspective with reference to externalities of all sorts, see Robert G. Hansen and John R. Lott, Jr., Externalities and Corporate Objectives in a World with Diverse Shareholder/Consumers, 31 J. Fin. And Quantitative Analysis 43 (1996). The theoretical notion that common ownership may induce firms to internalize the effect of one firm’s action on the value of other portfolio companies goes back to at least Daniel P. O’Brien & Steven C. Salop, Competitive Effects of Partial Ownership: Financial Interest and Corporate Control, 67 ANTITRUST L.J. 559 (2000). In a recent paper, Azar, Schmalz and Tecu present empirical evidence that common ownership of U.S. airlines by widely diversified investors may have resulted in higher ticket prices. Jose Azar, Martin C. Schmalz, and Isabel Tecu, Anticompetitive Effects of Common Ownership, 73 J Fin 1513, 1521-51 (2018). The results by Azar et al. have given rise to a significant body of scholarship, with varying results, on whether common ownership leads to anti-competitive effects. See, e.g., Matt Backus, Christopher Conlon and Mike Sinkinson, Common Ownership and Competition in the Ready-to-Eat Cereal Industry; Matt Backus, Christopher Conlon and Mike Sinkinson, Empirical Studies of the Effects of Common Ownership; other. A recent study by Azar and Vives attributes the initial results found by AST to common owners that are less diversified than universal owners. Jose Azar and Xavier Vives, Revisiting the Anticompetitive Effects of Common Ownership, Cite.

<sup>8</sup> Frederick H. Alexander, The Benefit Stance: Responsible Ownership in the Twenty-First Century, 36 Oxford Review of Economic Policy 341, 356 (2020).

<sup>9</sup> Madison Condon, Externalities and the Common Owner, 95 Washington L. Rev. 1, 45-47 (2020).

<sup>10</sup> Carbon Majors 2017 report cited in Condon n. 38.

economic interest to pursue this intervention and internalize the intra-portfolio climate externalities.

Condon suggests that universal owners should pursue a true portfolio maximizing strategy by forcing the internalization of climate externalities. By her calculations, universal owners would profit substantially by doing so. Indeed, she implies, they may be leaving huge amounts of money on the table by failing to do so. Even more interestingly, she generates this strong result within a “shareholder value” paradigm without considering the effects on stakeholders.

Similarly, a universal owner might push for strategies to reduce “systemic risk” from, e.g., financial crises. Jeff Gordon explores these strategies in a recent paper and takes as his paradigm the reduction of the risk posed to the financial system by “systemically important financial firms” (SIFIs). A universal owner concerned with systemic risk of this sort might vote “in support of management of a systemically important financial firm in a face-off with activist investors who want the firm to take greater risks to enhance shareholder returns.”<sup>11</sup> As Gordon points out, one lesson of the 2007-09 financial crisis is that “the failure of a SIFI can indeed result in losses across an entire portfolio. In deciding whether to support the risk-loving activist, the index-fund advisor ought to consider not only the return proposition at a single firm but the systematic risk effects.” In Gordon’s account, systemic stewardship is primarily a “reactive” strategy that merely asks shareholders to vote against a “risk loving activist” rather than a “pro-active” strategy to implement a different risk profile, and hence easier to implement.

Condon’s approach highlights the tradeoffs, although they are present in Gordon’s focus on the risks posed by SIFIs as well. A bank taking on “excessive” but legal financial risk by, e.g., buying back shares, raises the same set of issues posed by Exxon pumping “excessive” but legal amounts of oil. In both cases, there is a conflict between firm value and portfolio value. In both cases, we face the hard question of potential action by universal owners that produces a private and social good – reduction of environmental externalities or financial systemic risk – but at the cost of sacrificing a portfolio company that is complying with existing regulations.<sup>12</sup>

#### **b. The Limits on Potential Benefits**

The arguments by Alexander, Condon and Gordon would seem to present grounds for optimism. To lay the groundwork for our analysis, however, it is important to put universal ownership into perspective. Most importantly, universal owners are not all that universal and will have a variety of incentives that depend on firm specific factors. While universal owners will have some incentives to induce firms to internalize environmental, systematic risk-based, and other externalities, these incentives are limited and incomplete.

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<sup>11</sup> Gordon at 3.

<sup>12</sup> John Armour and Jeff Gordon, in an article focused primarily on systemically important financial institutions, argue that corporate law’s SFF results in excessive risk-taking from the perspective of the fully diversified shareholders and argue that this should lead to a change in corporate law fiduciary duties to promote a MFF. John Armour and Jeffrey Gordon, *Systemic Harms and Shareholder Value*, 6 J. Legal Analysis 35 (2014). Their argument can be extended to the governance of firms that generate climate externalities. *Id.* at 57.

First, many universal owners like BlackRock and Vanguard are not *owners* at all. Instead, they manage the assets for investors. Indeed, even entities that are technically asset owners like CalPERS or CalSTRS, as distinguished from asset managers, are run by individuals for the benefit of the beneficiaries. As we and others have discussed elsewhere, the incentives of agents managing money are different than the incentives of the beneficiaries of those assets.<sup>13</sup>

Second, universal owners are at most universal owners of businesses and thus will not have an incentive to internalize externalities that fall on individuals. This is true for externalities that directly affect individuals – say, health effects from environmental harms suffered by individuals – and for externalities that initially affect businesses but that businesses can transfer to individuals through the pricing mechanism – say, climate-change induced droughts that raise food prices.

Third, universal owners are not really *universal* owners of businesses. While some invest in private equity, private “pre-public” firms, and alternative asset classes like real estate,<sup>14</sup> many are primarily universal owners of *publicly traded* firms.<sup>15</sup> Moreover, U.S. based institutional investors – the most important universal owners for potentially influencing firm behavior – own a significantly greater fraction of U.S. firms than of non-U.S. firms. This is due to two factors. First, the publicly traded firms play a more significant role in the U.S. than in other countries.<sup>16</sup> Second, U.S. based institutional investors typically own a greater fraction of U.S. publicly traded firms than of non-U.S. publicly traded firms.<sup>17</sup> Institutional investors based in other countries tend to show similar local biases.

Relatedly, publicly traded companies will account for varying market shares in different industries. For example, in the U.S., four publicly traded companies account for virtually the entire domestic commercial airline industry. By contrast, other industries – accounting services, legal services, restaurants, residential real estate – are dominated by privately held companies. As a result, universal owners would have an interest in promoting the value of industries like airlines – which are dominated by publicly traded firms – at the expense of industries like restaurants – which are not – even if doing so reduces overall business profits.

Fourth, different universal owners have different allocation across different asset classes that create differing incentives. To start, the allocation of assets between debt and equity varies significantly among universal owners. Debt holdings are far less exposed than equity to climate change for at least three reasons: creditors get paid before shareholders; debt typically has a fixed return while equity receives a variable return; and debt has a limited, defined term while equity has an indefinite term. Because of these differences, a universal owner with more of its assets in “fixed income” instruments will have different incentives around climate change than a universal owner mostly invested in equities.

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<sup>13</sup> See, e.g., Edward Rock and Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders be Shareholders*, 100 B.U. L. Rev. 1753 (2020); Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2037 (2019); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 896 (2013), Scott Hemphill & Marcel Kahan. CITE.

<sup>14</sup> E.g., Blackstone, <https://www.blackstone.com/the-firm/>.

<sup>15</sup> E.g., TIAA-CREF. [https://www.tiaa.org/public/pdf/2Q21\\_Mutual\\_Fund\\_Capabilities\\_Overview.pdf](https://www.tiaa.org/public/pdf/2Q21_Mutual_Fund_Capabilities_Overview.pdf).

<sup>16</sup> Data

<sup>17</sup> Data.

More generally, different asset classes (and different investment strategies) will face different risks from climate change.

In sum, the degree to which universal owners will have incentives to induce portfolio companies to internalize externalities will vary. It will vary by which industries are affected by the externalities, by whether the externalities are mostly local or global; and by whether the externalities affect individuals or businesses.

### c. Externalities and Competition

Let us return to Condon's hypothetical. Condon posits that BlackRock should consider inducing Chevron and Exxon (which together account for more than 2% of annual industrial emissions) to reduce their emissions by 40%. Doing so, she argues, would result in a 20% decline in Chevron and Exxon's share prices and a \$6.3 billion loss of value to BlackRock. However, Condon calculates, the 1% net reduction in annual industrial emissions would increase the value of BlackRock's other holdings by \$9.7 billion, leaving BlackRock with a \$3.4 billion gain.

Buried in this hypothetical is an important assumption: that the actions that Chevron and Exxon take to achieve a 40% reduction in their emissions will not induce other companies to take actions that *increase* their emissions. Whether this assumption is correct depends on *how* Chevron and Exxon would reduce their emissions and, specifically, whether this opens up competitive opportunities for other companies.

Consider these examples. First, Exxon could reduce its emissions by selling assets to other oil companies, as Shell recently did with its Permian Basin assets.<sup>18</sup> While such a sale will help Shell meet its promised reductions in carbon emissions, it is unlikely to affect total carbon produced.<sup>19</sup>

Second, Exxon may reduce its emissions by reducing production from existing reserves, while retaining ownership of those reserves. By hypothesis, Exxon would have made profits by continuing production. If Exxon cuts production, another oil company with a single firm focus could profitably raise production from one of its existing fields or start producing oil from a new field. And companies with a single firm focus abound in the oil industry. For one, there are many important foreign energy companies – Saudi Aramco, Russia's Rosneft and Gazprom, Kuwait Petroleum Corporation, Petróleos de Venezuela S.A., the Nigerian National Petroleum Corporation and China's Sinopec – that are unlikely to fall under the sway of universal owners because they are state-owned or held by less diversified investors.<sup>20</sup> Even within the

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<sup>18</sup> Cara Lombardo and Collin Eaton, Shell to Sell Permian Assets to ConocoPhillips for \$9.5 Billion, WSJ Sept. 20, 2021. [https://www.wsj.com/articles/shell-near-deal-to-sell-permian-assets-to-conocophillips-11632168002?mod=Searchresults\\_pos13&page=1](https://www.wsj.com/articles/shell-near-deal-to-sell-permian-assets-to-conocophillips-11632168002?mod=Searchresults_pos13&page=1)

<sup>19</sup> Sarah McFarlane, Shell Vows to Speed Up Emissions Cuts in Wake of Court Ruling, WSJ June 9, 2021 at [https://www.wsj.com/articles/shell-to-speed-up-emissions-cuts-in-wake-of-court-ruling-11623236932?mod=article\\_inline](https://www.wsj.com/articles/shell-to-speed-up-emissions-cuts-in-wake-of-court-ruling-11623236932?mod=article_inline)

<sup>20</sup> See, e.g., Clifford Krauss, As Western Oil Giants Cut Production, State-Owned Companies Step Up, Oct. 14, 2021 NY Times <https://www.nytimes.com/2021/10/14/business/energy-environment/oil-production-state-owned-companies.html?smid=em-share>.

U.S., there are about 9,000 independent oil producers<sup>21</sup> who develop 91 percent of the wells in the United States and produce 83 percent of America's oil and 90 percent of America's natural gas.<sup>22</sup> The number of independent oil producers would probably increase further were Exxon not to pursue profitable opportunities. Moreover, active investors who hold less diversified portfolios than universal owners could accumulate sufficient shares in some of the publicly traded U.S. oil companies to induce them to expand their production or exploratory activities. Similarly, a third party could offer to buy a publicly traded company at a price between its MFF and SFF value, with the goal of returning the company to its higher SFF value. To the extent Exxon's production cut engenders any of these competitive responses, BlackRock would suffer the \$6.3 billion loss; but it would not obtain the full, or maybe any, benefits from an increase in the value of other portfolio companies due to a decline in annual industrial emissions.

Whether the supply response would fully offset Exxon's reduction depends on the extent to which Exxon enjoys competitive advantages in producing oil. Exxon's costs may be lower than those of its competitors, for example because of the location of the field reduces transportation costs or because terrain of the field reduces extraction costs. At the price for crude oil prevailing before Exxon's cut, it would then be unprofitable for some competitors to produce oil – otherwise they would have done so before Exxon cut its emissions. Exxon's cut could thus generate an increase in price and a corresponding increase in production by Exxon competitors, albeit an increase by less than the initial Exxon cut. To that extent, there would be a net decline of emissions, but a decline in a magnitude lower than the Exxon's reduction in emission, and a lower increase the value of other BlackRock's holdings.

On the other hand, Saudi Arabia, a dominant oil producer, may try to manage the global supply and the market price of crude oil. Saudi Arabia may be able to increase production to make up for Exxon's cut at the oil price prevailing before Exxon's cut. To that extent, Exxon's actions, while reducing Exxon's emissions and its value, would have no effect on overall emissions.

Third, Exxon could reduce its emissions in ways that are unlikely to engender a competitive response. Rather than reducing its output, it could make its own production more energy efficient through changes in its operations. To illustrate with a trivial example, suppose that Exxon chooses to reduce carbon output by installing energy efficient windows in its offices that are not cost justified, on their own. While these actions may lower Exxon's profits by making production less cost efficient, at least in the short term, they would not create competitive opportunities for other firms.<sup>23</sup> Exxon's actions, of course, could lead to an increase in the price of energy efficient windows both in the short run and, to a lesser extent, in the long run. And this price increase would, in turn, induce others not to install energy efficient windows.

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<sup>21</sup> The U.S. Internal Revenue Code section 613A(d) defines an independent producer as a producer who does not have more than \$5 million in retail sales of oil and gas in a year or who does not refine more than an average of 75,000 barrels per day of crude oil during a given year.

<sup>22</sup> <https://www.ipaa.org/independent-producers/>

<sup>23</sup> To be sure, other firms may not follow Exxon's footsteps by installing energy efficient windows. If they do not, while other firms may be more profitable than Exxon, they would not make even more money by installing even less energy efficient windows than before. Over the long term, Exxon's reduced profitability may make Exxon non-competitive and force it to scale down and Exxon may be replaced by another firm. This may not happen for a long time, if it ever happens.



Whatever action Exxon takes, therefore, market responses will at least partially mitigate the direct reduction in emissions from Exxon's actions. Without knowing specifics, and analyzing the market response, BlackRock could not be confident that inducing Exxon to cut emissions would raise the value of its overall portfolio holdings.

The task that universal owners like BlackRock face is thus far more complicated than Condon's hypothetical suggests. It would require not only a valuation of the economic benefit generated by a reduction in emissions for BlackRock's portfolio companies and the economic costs to Exxon and Chevron. It would also require an understanding of the ways in which Exxon and Chevron would cut emissions, the competitive dynamics in the oil industry, the cost structure under which Exxon, Chevron and its competitors operate, and the extent to which competitive opportunities would be exploited by publicly held companies in which BlackRock holds a stake or other entities. Indeed, a mere instruction to Exxon and Chevron to cut emissions by 40% may do no good – and no harm as Exxon and Chevron could just sell portions of their operations to a competing firm, for a fair price, with no effect on total emissions and no effect on their stock valuations.

By contrast, strategies that cut emissions without reducing profits pose far fewer problems. To vary Condon's hypothetical, assume that Exxon cutting emissions by 4% would have no effect on Exxon's profits or even raise profits by a small amount (e.g. because the projects cut would not have been profitable at the margin) while at the same time increasing the value of other BlackRock's holdings by \$0.97 billion. Since Exxon's activities were not profitable, there is no concern that their discontinuation would engender a competitive response. And even though the emissions cut would have no significant effect on Exxon's profits, it would benefit BlackRock.

Universal owners thus have incentives to induce portfolio companies to take actions (like stopping pollution) that have no material impact on their value but generate positive externalities. Importantly, this task would be much easier than trade-off strategies for two reasons. First, and more obviously, they would have to assess only the direction, but not the magnitude, of externalities to determine whether the action is in their interests. Second, they would not have to worry about competitive reactions. But, of course, merely inducing companies to refrain from actions that are not profitable to start with offers far less potential for substantial reductions in environmental or other externalities.

## **II. The Deep Architecture of Corporate Law**

Alexander, Condon, Gordon all argue that an investor with a diversified portfolio has financial incentives to adopt a portfolio-wide or multi-firm focus. Even if true, such an MFF is in tension with traditional corporate law principles in a variety of ways. These tensions are likely to inhibit universal owners from pursuing an MFF approach and to make that approach, if pursued, less effective.

In this section, we first describe corporate law's single firm focus. We then discuss how corporate law understands the interests of shareholders as the interests in a particular firm and unrelated to their extraneous or portfolio interests. Next, we summarize the board's obligation to manage for the benefit of *all* the shareholders and not just the most powerful ones. Finally, we review shareholders' general right to vote their shares selfishly and the traditional limits to that right. Each of these principles stands in the way of implementing systemic stewardship with tradeoffs.

### a. Corporate Law's Single Firm Focus

The traditional description of the properties of the corporate form is that “the objective of a corporation is to promote the value of the corporation, within the boundaries of law, for the benefit of the corporation’s shareholders.”<sup>24</sup> This description includes two key aspects: first, the objective of a corporation is to promote the value of *this particular corporation*; second, the value of this corporation is for the benefit of *all* its shareholders. The SFF of corporate law has not received nearly as much attention as the issue of whether corporations are managed for the benefit of the shareholders (sometimes referred to as “shareholder primacy”) or for some broader group of stakeholders (“stakeholderism”), possibly because the SFF is so fundamental to corporate law and corporate governance that it is hardly noticed.

Here we describe just some of the ways in which SFF is a fundamental principle in corporate law. First, the critically important business judgment rule -- the commitment that courts will not second-guess business judgments -- is entirely SFF. As the Delaware Supreme Court explained in *Aronson v. Lewis*, the BJR creates a “presumption that in making a business decision, the directors of a corporation acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was *in the best interest of the company*.”<sup>25</sup>

Fiduciary duties are likewise single firm focused: “directors owe fiduciary duties to the corporation and its shareholders.”<sup>26</sup> The classic language from *Guth v. Loft, Inc.*<sup>27</sup> has a clear SFF:

A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.

The fiduciary duty of loyalty has been summarized as mandating “that the best interest of the corporation and its shareholders take[] precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.”<sup>28</sup>

The very definition of what counts as an “interested” director or controller likewise focuses on a specific corporation. Generally, a director or controller is “interested” in a transaction or conduct involving a corporation if the director or controller is a party to the transaction or conduct or if the director or

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<sup>24</sup> See Restatement 2.01(a) DRAFT.

<sup>25</sup> *Aronson v. Lewis*, Del. Supr., 473 A.2d 805, 812 (1984)(emphasis added). As discussed below, the best interest of the company intrinsically includes the interests of shareholders qua shareholders (or, from a stakeholder perspective, the interest of other stakeholders, qua stakeholders), but does not include the extraneous interests of shareholders.

<sup>26</sup> *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1988).

<sup>27</sup> *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

<sup>28</sup> *Cede III*, 634 A.2d at 361 (citing *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984)), cited in *Disney II* at \*\*164.

controller receives a benefit as a result of the transaction or conduct that is not shared pro rata according to the number of shares held. “Interest” is thus relative to a particular corporation with interests in other corporations potentially rendering a director or controller not disinterested.

Definitions of “good faith” and the related concept of “bad faith” are also SFF. In Chancellor Chandler’s detailed exploration of Delaware precedent in *In re Walt Disney Co. Derivative Lit.*,<sup>29</sup> he captured this SFF:

- “Bad faith has been defined as authorizing a transaction ‘for some purpose other than a genuine attempt to advance corporate welfare . . .’”<sup>30</sup>
- “Bad faith (or lack of good faith) is when a director acts in a manner ‘unrelated to a pursuit of the corporation’s best interests.’ It makes no difference the reason why the director intentionally fails to pursue the best interests of the corporation.”<sup>31</sup>
- “To act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation.”<sup>32</sup>
- “The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty . . . but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders.”<sup>33</sup>

The outrage with which a court views fiduciaries with conflicting interests is another indication of the SFF of fiduciary duties. As the Delaware Supreme Court thundered in *Weinberger v. UOP*, “there is no ‘safe harbor’ for . . . divided loyalties in Delaware. . . There is no dilution of this obligation where one holds dual or multiple directorships . . .”<sup>34</sup>

Finally, in the Delaware court’s review of defensive tactics in control contests under the Unocal/Unitrin standard, there is a clear SFF. The board’s power to act in response to a tender offer “derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source.”<sup>35</sup> When responding to a pending takeover bid, the board “has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders.” Given the “omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders,” the court announced a threshold examination before the business judgment rule would attach. In this examination, the first step is the identification of a “danger to corporate policy and effectiveness.”<sup>36</sup>

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<sup>29</sup> 907 A.2d 693, 753 (Del. Ch. 2005)

<sup>30</sup> Id. at 753 citing *Gagliardi*, 683 A.2d at 1051 n.2 (citing *Miller v. AT&T*, 507 F.2d 759 (3d Cir. 1974), emphasis in original).

<sup>31</sup> Id. at 754 (footnotes and citations omitted).

<sup>32</sup> Id. at 755.

<sup>33</sup> Id. at 755.

<sup>34</sup> *Weinberger v. UOP*, 457 A.2d 701, 710 (1983).

<sup>35</sup> *Unocal*, 495 A.2d 946, 954 (Del. 1985) citations omitted.

<sup>36</sup> Indeed, the Unocal court’s explicit rejection of Frank Easterbrook and Dan Fischel’s “passivity” thesis is, in significant degree, a rejection of the MFF that formed the foundation of their argument. As they argued, the increased merger premium that defensive measures might secure was unimportant as it was largely a transfer among fully diversified shareholders, while the threat of hostile tender offers would increase the value of their overall portfolios.

The limit case – a company with wholly owned subsidiaries – highlights the single firm focus of the normal case. Wholly owned subsidiaries present a special case because, by construction, there are no possible conflicts of interests among shareholders. While the law is clear that the directors of a solvent wholly owned subsidiary should pursue the interests of the parent company,<sup>37</sup> in all other cases (e.g., a partially owned subsidiary), the directors should pursue the interests of the subsidiary itself.<sup>38</sup> Put differently, extraneous interests of shareholders – as to which shareholder interests may conflict – are problematic except in the special case where there is no potential for conflicts of interest among shareholders because the company has only a single shareholder.

#### **b. Single Firm Focus, Shareholder Primacy and Stakeholderism**

As noted above, in the traditional formulation, the corporation is managed “for the benefit of shareholders” and the articulation of various duties often talks about “the corporation and its shareholders.” This raises two important issues. First, how does corporate law understand shareholders’ interests. Second, how does SFF relate to the lively debate over whether corporate law does, and should, enshrine shareholder primacy: the principle that the corporation should be managed for the principal benefit of its shareholders, rather than for the benefit of multiple constituencies, such as employees and customers.

In the traditional understanding, the focus is on shareholders qua shareholders of a particular firm, taking into account their interests only insofar as the interests relate to shareholders’ relationship with the company and, importantly, ignoring their “extraneous” or outside interests, including their portfolio interests.

The focus on shareholders qua shareholders of a given corporation – to the exclusion of shareholders’ extraneous interests – is best illustrated by *Revlon*. *Revlon* involved a bidding contest for Revlon between Forstmann and Pantry Pride, a company owned by Ronald Perelman. In the contest, the board of Revlon had accepted a bid by Forstmann that entailed a lockup and cancellation fee for the benefit of Forstmann valued at \$125 to \$200 million. In exchange, Forstmann had promised to support the par value of certain Revlon notes that had declined in value after the Revlon board agreed to waive certain note covenants. The court’s opinion criticized the board’s attempt for secure benefits for Revlon’s noteholders, holding that “concern for non-stockholder interests is inappropriate” when a company is sold for cash.

While *Revlon*’s holding is often cited as an endorsement of shareholder primacy, its significance extends further. The *Revlon* decision notes that Forstmann had promised to support had been issued by Revlon only one month before pursuant to an exchange offer for its own shares in which 87% of Revlon’s shareholders participated. When the exchange offer closed, the vast majority of Revlon’s shareholders were also noteholders and, in all likelihood, this picture had not changed fundamentally by the following month. Thus, Revlon noteholders were largely Revlon shareholders – and supporting the price of the

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<sup>37</sup> *Trenwick American Litigation Trust v. Ernst & Young, LLP*, 906 A.2d 168, 201 (Del. Ch. 2006), citing *Anadarko Petro. Corp.*, 545 A.2d at 1174 (citing *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)). See also *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 184 (Del. Ch. 2014).

<sup>38</sup> For an interesting discussion of these SFF principles as applied to directors appointed by a particular shareholder or group of shareholders, see Travis Laster and John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 *Bus. Law.* 33 (2015).

notes would have benefitted these shareholders. Nevertheless, the Delaware Supreme Court was clear that this type of benefit – which derives from shareholders’ extraneous interests (the ownership of notes by persons who also happen to be shareholders) rather than their interests qua shareholders – should have been ignored.

Stakeholderism expands the range of interests that count to include non-shareholder constituencies, but the single firm focus remains. In a stakeholder jurisdiction, the board is typically given permission to consider non-shareholder interests (e.g., the interests of employees or creditors), but the permission is in the context of “considering the best interests of the corporation.”<sup>39</sup> This clear SFF implies that only the interests of shareholders qua shareholders of this company, the interests of employees qua employees of this company, or the interests of creditors qua creditors of this company, should enter the company’s calculus. Indeed, given the variety of extraneous interests that can arise as one considers additional stakeholders, a stakeholder approach may be even more SFF than a shareholder primacy view. As a result, the shareholder v. stakeholder debate is largely orthogonal to our concerns here: both approaches incorporate a deep SFF.

Because shareholder primacy remains the dominant framework under which most corporations operate, the discussion in this paper will be mostly premised on shareholder primacy. However, it bears noting that the arguments advanced by Alexander, Condon and Gordon are stronger in a shareholder primacy setting than under stakeholderism. Their arguments are all premised on the existence of large, highly diversified *shareholders* who therefore have substantial extraneous portfolio interests. Thus, BlackRock’s overall portfolio holdings (which give rise to potential extraneous interests) dwarf its holdings in any particular company (its interests in a company qua shareholder). Other corporate constituents – employees in particular – are not equivalently diversified and therefore hold comparatively smaller extraneous interests. For example, Exxon cutting its emissions by 40% – raising the prospect that many Exxon employees would lose their jobs, that Exxon would buy less from its suppliers, or that Exxon would raise its price to or cut off some of its customers – may well not be in the interests of Exxon’s stakeholders even if it benefits Exxon’s universal shareholders.

### **c. Corporate Law’s “Egalitarian” Focus: for *all* the shareholders**

When it is said that a corporation is managed “for the benefit of the shareholders,” what exactly does that mean? For the benefit of which shareholders?

If shareholder interests are understood as the interests of shareholders qua shareholders of a given company -- abstracting from the interests of the actual shareholders who will often have “extraneous” interests -- then the principal focus is on the interest that all shareholders have in common, namely, maximizing the value of the company. This results in a highly stylized conception of shareholders’ interests that often departs from shareholders’ actual interests, and, in doing so, avoids all of the complex issues that arise in reconciling heterogeneous interests and preferences.<sup>40</sup>

Shareholders, of course, may have different views on *how* a company should go about in maximizing its value. From the beginning, corporate law has embraced indirect majority rule, providing for the election

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<sup>39</sup> 15 Pa. Consol. Stat. § 1715.

<sup>40</sup> Henry Hansmann, *The Ownership of Enterprise* CITE.

of directors by a majority or plurality of the shares voting, while tasking directors with the management of the company.

Giving power to holders of a majority of shares, however, generates a problem. Holders of a majority of the shares may use this power not merely to resolve differences of opinion on how to maximize the value of the corporation for shareholders at large, but to pursue their own self-interest. This problem is most acute if there is a single shareholder, or a group of affiliated shareholders, who own a majority of the shares or otherwise control the corporation.

One way to constrain this abuse was to require that the majority's power to decide must be used for the benefit of *all the shareholders*. Thus, in *East Rome Town Co. v. Nagle*,<sup>41</sup> a court blocked the attempt of a majority shareholder to convert a toll bridge owned by the corporation into a free bridge (which would advantage the majority shareholder) on the grounds that the corporation must use the bridge franchise for the profit of the corporation (and thus for all shareholders ratably). Similarly, in *Ervin v. Oregon Railway & Navigation Co.*,<sup>42</sup> the court recognized the power of the majority to dissolve the corporation, but then required that the majority account to the minority for the fair value of the assets sold.<sup>43</sup>

This principle has deep roots in Delaware corporate law. In *Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am.*, a seminal decision on the fiduciary duties of a controlling stockholder, the court stated that:

The same considerations of fundamental justice which impose a fiduciary character upon the relationship of the directors to the stockholders will also impose, in a proper case, a like character upon the relationship which the majority of the stockholders bear to the minority. When, in the conduct of the corporate business, a majority of the voting power in the corporation join hands in imposing its policy upon all, it is beyond all reason and contrary, it seems to me, to the plainest dictates of what is just and right, to take any view other than that they are to be regarded as having placed upon themselves the same sort of fiduciary character which the law impresses upon the directors in their relation to all the stockholders. Ordinarily the directors speak for and determine the policy of the corporation. When the majority of stockholders do this, they are, for the moment, the corporation. Unless the majority in such case are to be regarded as owing a duty to the minority such as is owed by the directors to all, then the minority are in a situation that exposes them to the grossest frauds and subjects them to most outrageous wrongs.<sup>44</sup>

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<sup>41</sup> 58 Ga. 474 (1877) discussed in Smith at 312.

<sup>42</sup> 27 F. 625, 630 (S.D.N.Y. 1886).

<sup>43</sup> As Gordon Smith points out, this principle is the origin for what we now think of as the shareholder primacy norm. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. Corp. Law 277, 279 (1998) ("Nevertheless, when early courts employed rules requiring directors to act in the interests of all shareholders – not just the majority shareholders – they were creating the shareholder primacy norm.")

<sup>44</sup> 120 A. 486, 491 (Del. Ch. 1923) (collecting authorities); accord *Epstein v. Celotex Corp.*, 238 A.2d 843, 847 (Del. Ch. 1968); see 18 C.J.S. Corporations § 394 ("When a stockholder exercises control over the corporation by directing its actions, the stockholder assumes the same fiduciary duties as those owed by a director to the corporation."). Cited and discussed by VC Laster in *Firefighters' Pension System of the City of Kansas City, Missouri Trust v. Presidio, Inc.*, 2021 Del. Ch. LEXIS 15 at \*81-82.

The board's obligation to manage the corporation for the benefit of all the shareholders has, over time, extended to imposing (limited) fiduciary duties on controlling shareholders. Unlike officers and directors, shareholders do not automatically owe fiduciary duties to the corporation. Rather, shareholders take on fiduciary duties when they become controllers, whether as a result of owning a majority of the corporation's shares or as a result of exercising actual control. For example, corporate transactions or conduct in which controllers have an interest that is different from the general shareholder interest trigger the duty of loyalty. Thus, for example, when a controller freezes out non-controlling shareholders in a going-private transaction, the controller must establish the fairness of the transaction unless it adopts procedures that cleanse the transaction of the taint of self-dealing including an effective special committee of disinterested directors empowered to negotiate and to say no, as well as a fully informed, uncoerced vote of the unaffiliated shares.<sup>45</sup>

The use of majority power to oppress minority shareholders in closely held corporations developed into the "minority oppression" remedy,<sup>46</sup> but the underlying principle remains of general application: the corporation must be managed for the benefit of all the shareholders and not just the majority shareholder.<sup>47</sup>

#### d. Shareholders' Limited Duties: Selfish Voting

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<sup>45</sup> Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014). But controllers' duties *may* extend further. As Chancellor William T. Allen explained, "when a shareholder, who achieves power through the ownership of stock, exercises that power by directing the actions of the corporation, he assumes the duties of care and loyalty of a director of a corporation." Cinerama, Inc. v. Technicolor, Inc., 1991 WL 111134, at \*19 (Del.Ch.)(Allen, C.), *aff'd* in part, *rev'd* on other grounds *sub nom*, 634 A.2d 345 (Del.1993), cited and quoted with approval in Pfeffer v. Redstone, 965 A.2d 676, n. 52 (Del. 2009). See also, Harris v. Carter, 582 A.2d 222, 234 (Del. Ch. 1990) (Allen, C.) (citing Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 109–10 (Del. 1952))("when a shareholder presumes to exercise control over a corporation, to direct its actions, that shareholder assumes a fiduciary duty of the same kind as that owed by a director to the corporation."). Here, Chancellor Allen explained, the protective device of fiduciary duties substitutes for the "protection that a corporation or its shareholders ordinarily receives from the business judgment of the men and women who comprise the company's board of directors." *Id*.

<sup>46</sup> Smith at 310-22.

<sup>47</sup> The U.K. cases reflect a similar "abuse of majority" principle according to which majorities must use their power over the corporation for the benefit of all, at least in some circumstances. In the leading 1900 case of *Allen v. Gold Reefs of West Africa Ltd*, [1900] 1 Ch 656 at 671, [1900–3] All ER Rep 746 at 749 - 750, the court held, in relation to a power conferred on the majority of shareholders to alter the articles of association, that:

The power thus conferred on companies to alter their articles is limited only by the provisions contained in the statute and the conditions contained in the company's memorandum of association. Wide, however, as the language of s. 50 [of the Companies Act 1862] is, the power conferred by it must, like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded. These conditions are always implied, and are seldom, if ever, expressed.

See, also, the discussion of this principle in connection with bond exit consents in *Asseignagon v. Irish Bank*. While the development of this principle in U.K. company law is complex (for reasons explored below), and the decisions to which it applies remain unclear, the core concern with minority oppression remains alive and important. Indeed, the key phrase from *Allen v. Gold Reefs* – "bona fide for the benefit of the company as a whole" – captures both of the aspects we have been discussing. The actions must be bona fide for the benefit of *this* company, and for the benefit of this company *as a whole* (and not just for the benefit of the majority).

There are two respects in which corporate law bows to the right of shareholders to pursue their self-interest: any shareholder, including a controller, may generally vote and sell shares selfishly.

Here the tension with the “abuse of majority” principle outlined above is immediately apparent. The leading Delaware case is *Bershad v. Curtiss-Wright* in which the plaintiff argued that the majority shareholder’s policy against selling its controlled subsidiary breached its fiduciary duties and that it should have auctioned the corporation. Rejecting this claim, the Delaware Supreme Court provided the iconic statement that is typically cited for the proposition that shareholders, including controlling shareholders, may vote selfishly:

Stockholders in Delaware corporations have a right to control and vote their shares in their own interest. They are limited only by any fiduciary duty owed to other stockholders. It is not objectionable that their motives may be for personal profit, or determined by whim or caprice, so long as they violate no duty owed other shareholders.<sup>48</sup>

In our context, what is so interesting about this statement is its limitations, “whim or caprice, so long as they violate no duty owed to other shareholders.” When applied to controllers, this imports the case law imposing duties to other shareholders when acting through the board.

The right to vote selfishly is conceptually most important when shareholders vote on matters *other than* the election of directors. To be sure, shareholders may also vote selfishly for directors, “for personal profit,” but directors are not permitted to act to further the personal profits of some shareholders and at least controlling shareholders could be subject to personal liability if directors so act. While fiduciary duty law in these respects is surely not perfectly enforced, it imposes constraints on the ability of shareholders to benefit from selfish votes in director elections and even greater constraints on how shareholders and directors may campaign for elections. As to other matters shareholders vote on, they are legally free to oppose and defeat a merger or a charter amendment, even if they acknowledge that the measure would be valuable for the company. By contrast, when a controlling shareholder acts affirmatively – e.g., through the enactment of a bylaw – the limitation on *Bershad’s* permission to vote selfishly becomes relevant: a shareholder adopted bylaw may be held void if adopted for an inequitable purpose.<sup>49</sup>

Shareholders are also free to vote in their self-interest on precatory shareholder resolutions. Votes on precatory shareholder resolutions fall between votes on director elections and votes on merger and charter amendments. On one hand, these resolutions are not self-effecting but are addressed to the board. And the board, of course, has to consider its own fiduciary duties in deciding whether to heed them. On the other hand, directors themselves are not directly involved in these resolutions. This dual nature means that shareholders may sometimes campaign in favor of resolutions on the basis of goals other than the best interest of the corporation. But if such a resolution then obtains majority support, such campaigning would make it harder for directors to implement the resolution.

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<sup>48</sup> *Bershad v. Curtiss-Wright*, 535 A.2d 840, 845 (Del. 1986).

<sup>49</sup> *Hollinger Int’l v. Black*, 844 A.2d 1022, 1080-82 (Del. Ch. 2004), affirmed 872 A.2d 559 (Del. 2005) (bylaw adopted by controlling shareholder void because adopted for inequitable purpose).



### III. Implementing Climate Stewardship

Let us assume that Condon's calculation is correct, that in a static model, forcing Exxon and Chevron to reduce carbon production by 40% would substantially benefit the portfolios of universal owners despite the fact that Exxon and Chevron's stock price would decline by 20%. How might this strategy be implemented? What legal and political risks would it entail? Are there alternative strategies with less legal risk? Would those alternative strategies significantly reduce carbon emissions?

#### a. Embracing the Hypo with Enthusiasm: a hypothetical campaign

Suppose that BlackRock, Vanguard and State Street ("BVS"), the three largest "universal owners", were to team up explicitly to elect new boards at Exxon and Chevron committed to reducing Exxon and Chevron's carbon output by 40%, despite clear evidence that doing so would reduce its stock price by 20%?<sup>50</sup> What regulatory or corporate law obstacles and risks would they run? We will review some of them, although there are likely additional risks as well.

First, having formed a "group" for the purpose of voting their shares, they would no longer qualify to file Schedule 13G but would now have to file a joint Schedule 13D disclosing their holdings and amend that filing when holdings or intentions changed. While filing a Schedule 13D would not, itself, be particularly burdensome, amendments would add to the burden and, even more problematic, filing 13D would necessitate a fundamental change in practice at each adviser, as currently they only file 13Gs.

Second, Section 16 incorporates the Section 13(d) concepts of beneficial ownership.<sup>51</sup> As a result, this group of universal owners collectively holding more than 10% would likely find itself subject to Section 16(b)'s prohibition on "short swing" trading. This would be very burdensome for BlackRock, Vanguard and State Street as they buy and sell shares as money flows into and out of their funds because, under Section 16(b), such beneficial owners must disgorge any profit made or loss avoided from "any purchase and sale, or any sale and purchase" within six months.<sup>52</sup>

Third, having shifted from "passive" holders to "active" holders, the Hart-Scott-Rodino Act would impose advanced notice and pre-clearance requirements on additional purchase of shares of either company. In a period when funds were flowing into their index funds, this would complicate matters significantly, increasing tracking error and expenses. Indeed, depending on how broadly the Hart-Scott-Rodino reporting requirements were applied to BVS, it could spell the end of index funds.

Fourth, they would have to file a proxy statement and comply with the detailed disclosure requirements set by the SEC.

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<sup>50</sup> The actual calculation required by Condon's hypothetical, with its tradeoff over various margins, is complex. It is unclear whether universal owners, as currently configured, have the expertise to calculate such tradeoffs accurately. Were this to become a major strategy, however, they could acquire the expertise.

<sup>51</sup> Rule 16a-1(a)(1); *CSX v. TCI*, 654 F.3d 276, 290-94 (2d Cir. 2011)(Winter, concurring). See also, *Rubenstein v. International Value Advisers LLC*, 959 F.3d 541 (2d Cir. 2020). The filing of a Schedule 13D by BVS would likely disqualify BVS from relying on the 13G Institution exemption from 16(b) under Rule 16a-1. SEC, Ownership Reports and Trading by Officers, Directors and Principal Security Holders, SEC Release No. 27148, 24942, 17112, 34-27148, , 54 FR 35667, 1989 WL 1093497 (1989).

<sup>52</sup> 1934 Act § 16(b).

While none of these regulatory burdens is even close to a show-stopper for activist hedge funds, they would be sufficient to dissuade index funds from taking an active role in pursuing Condon's strategy.

Even more concerning would be the risks under Delaware corporate law. By hypothesis, this campaign will benefit BlackRock, Vanguard, State Street and other universal owners/managers at the expense of undiversified shareholders of Exxon and Chevron. In order to examine these risks, let us assume that the campaign is successful and that the BVS slate of directors is elected. Let us assume further that, having been elected, they implement Condon's proposed strategy, credibly commit to cut carbon emissions by 40% within three years, with an immediate 20% drop in the stock price.

In the wake of the boards' decision and the drop in the stock price, litigation is brought on behalf of Exxon and Chevron shareholders against the directors of each company and against BlackRock, Vanguard and State Street as a collective "controlling shareholder" and for "aiding and abetting" the directors' breach of their fiduciary duties. The complaints allege breaches of the duty of loyalty against all the defendants and probably waste as well. The essence of all the claims is the same: the decision was made to benefit the universal owners rather than Exxon and Chevron.

In this robust form of climate change activism, in which universal owners team up to elect a new board committed to the strategy, these would be very substantial claims. We will briefly work through the steps.

First, the claims would be derivative not direct: the harm to shareholders derives from the reduction in the value of Exxon and Chevron by virtue of adopting the low carbon strategy.<sup>53</sup> While the claims would be derivative, however, under the terms of the hypo, demand would clearly be futile: by hypothesis, the directors have all committed themselves to the BVS low carbon strategy, and can hardly be expected to evaluate the strength of the claims against themselves or BVS for breach of the duty of loyalty or any of the other claims.

Second, on the merits, the claims against the directors would be strong, because the hypothetical, unrealistically, is close to a confession of disloyalty. After all, the BVS campaign, by its terms, seeks portfolio benefits for BVS while knowing that it will involve a substantial cost to Exxon and Chevron. With respect to the directors, corporate law's fundamental principles described above – the SFF and the "egalitarian" commitment to managing the corporation for the benefit of all the shareholders and not just the most powerful – would both condemn the conduct. First, the goal of benefiting the portfolio interests of powerful shareholders over the interests of the corporation is an improper goal. Second, benefiting those powerful shareholders at the expense of the other shareholders is a likewise off-limits. Similarly, the fact that some other, smaller shareholders may share BVS's interests would be to no avail. Such conduct by directors would, under Delaware case law, constitute lack of "good faith" and, in doing so, would violate the duty of loyalty and expose directors to the risk of personal liability. While Delaware law permits companies to exculpate directors from monetary liability for breach of fiduciary duties by charter provision, that provision may not eliminate or limit liability "for any breach of the

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<sup>53</sup> Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Del. 2004).

director's duty of loyalty to the corporation or its stockholders" or "for acts or omissions not in good faith." <sup>54</sup>

The claims against BVS are more complicated. After all, none individually has sufficient power to control. Their liability, then, would depend on whether a court would find that, together, they constituted a "controller."

Delaware law recognizes that "multiple stockholders together can constitute a control group exercising majority or effective control, with each member subject to the fiduciary duties of a controller."<sup>55</sup> To establish group control, the shareholders must be:

"connected in some legally significant way"—such as "by contract, common ownership, agreement, or other arrangement—to work together toward a shared goal." To show a "legally significant" connection, the Appellants must allege that there was more than a "mere concurrence of self-interest among certain stockholders." Rather, "there must be some indication of an actual agreement," although it need not be formal or written.<sup>56</sup>

Here, of course, the hypo's explicit agreement between BVS likely establishes the necessary legally significant connection.

Finally, depending on the relationship between BVS and the directors who they nominated, there would be a decent argument that the group had effective control over the companies. For example, if the successful nominees were all employees of BlackRock, Vanguard or State Street, that would be powerful evidence of control. Similarly, if the directors, while not BVS employees, nonetheless had committed to implement the "low carbon" strategy as part of their agreement to be nominated to the board, that would also be some evidence that BVS were pulling the strings, at least as to the "low carbon" initiative. While a collective ownership of around 20-25% is at the bottom end of what is typically held to be sufficient to become a controller,<sup>57</sup> it could suffice when combined with control over the board of directors. Whether disbanding the group after the successful proxy contest would be sufficient to prevent BVS from being considered a joint controller would inevitably be litigated.

Even if a court were unconvinced that BVS jointly controlled Exxon and Chevron, and BVS thus did not have fiduciary duties, they could still face liability for "aiding and abetting" the directors' breach of fiduciary duty. To establish "aiding and abetting" liability, one must show (i) the existence of a fiduciary relationship, (ii) a breach of the fiduciary's duty, (iii) knowing participation in the breach by a non-fiduciary defendant and (iv) damages proximately caused by the breach.<sup>58</sup> Here, the relevant fiduciary relationship would be that of the directors. The fiduciary's alleged breach would be the directors' breach of their duty of loyalty in pursuing a goal other than Exxon's interests. "Knowing participation" in a fiduciary's breach requires that the alleged aider and abettor "act with the knowledge that the conduct

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<sup>54</sup> Del. GCL § 102(b)(7). For a similar argument, see J. Travis Laster, *Fiduciary Duties in Activist Situations*, 13 VA. L. & BUS. REV. 75 (2019).

<sup>55</sup> *Sheldon v. Pinto Tech. Ventures, L.P.*, 220 A3d 245, 251 (Del. 2019)(citing cases).

<sup>56</sup> *Id.* at 251-52 (citations omitted).

<sup>57</sup> *Tornetta v. Musk*

<sup>58</sup> *Malpiede v. Townson*, 780 A.2d 1075, 1096 (Del. 2001); *Firefighters' Pension Sys. v. Presidio, Inc.*, 2021 Del. Ch. LEXIS 15 at \*103. See, also, Restatement (Second) of Torts, § 876.

advocated or assisted constitutes such a breach.”<sup>59</sup> On the facts of the hypothetical, plaintiffs would argue that BVS formulated and implemented the strategy and, in doing so, caused the board (which it elected) to make the decision at issue.<sup>60</sup> Finally, the resulting 40% decline in production and 20% decline in the stock price would be damages proximately caused by the breach.

**b. Pursuing a Condon “trade-off” strategy would conflict with Universal Owners’ business model and legal obligations to clients.**

“Universal owners” are, in fact, managers of money for the benefit of clients. Thinking about the plausibility of universal owners pursuing an active climate risk mitigation strategy requires thinking about these firms’ businesses and legal obligations to customers or clients. BlackRock, e.g., in its 10-k, describes its business as follows:

BlackRock, Inc. (together, with its subsidiaries, unless the context otherwise indicates, “BlackRock” or the “Company”) is a leading publicly traded investment management firm with \$8.68 trillion of assets under management (“AUM”) at December 31, 2020. With approximately 16,500 employees in more than 30 countries who serve clients in over 100 countries across the globe, BlackRock provides a broad range of investment management and technology services to institutional and retail clients worldwide.

BlackRock’s diverse platform of alpha-seeking active, index and cash management investment strategies across asset classes enables the Company to tailor investment outcomes and asset allocation solutions for clients. Product offerings include single- and multi-asset portfolios investing in equities, fixed income, alternatives and money market instruments. Products are offered directly and through intermediaries in a variety of vehicles, including open-end and closed-end mutual funds, *iShares*® exchange-traded funds (“ETFs”), separate accounts, collective trust funds and other pooled investment vehicles. ... The Company is highly regulated and manages its clients’ assets as a fiduciary. ...

BlackRock serves a diverse mix of institutional and retail clients across the globe. Clients include tax-exempt institutions, such as defined benefit and defined contribution pension plans, charities, foundations and endowments; official institutions, such as central banks, sovereign wealth funds, supranationals and other government entities; taxable institutions, including insurance companies, financial institutions, corporations and third-party fund sponsors, and retail intermediaries.

While Vanguard pursues a different, consumer focused strategy that emphasizes low costs, it too runs dozens of different mutual funds, including both equity and fixed income products, with different goals and targeted to different customers.

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<sup>59</sup> Malpiede, 780 A.2d at 1097.

<sup>60</sup> Id. at 1098.

Any sort of “trade-off” strategy of the sort proposed by Condon would wreak havoc on universal owners’ business model.<sup>61</sup> While the “low carbon” strategy might be optimal for the investors in an S & P 500 index fund, as Condon argues, it will not be optimal for investors in an energy ETF in which Exxon and Chevron are significant holdings. For example, a decline of 20% in the stock price of Exxon and Chevron would be devastating to the investors in BlackRock’s \$2.6 billion U.S. Energy ETF (holdings: Exxon 23.64%; Chevron 17.92%),<sup>62</sup> or Vanguard’s \$6.2 billion Energy ETF (holdings: Exxon 21.37%; Chevron 17.26%).<sup>63</sup> The strategy could also negatively impact actively managed portfolios. How would BlackRock or Vanguard explain to the current or prospective investors in the Energy ETFs why they supported a strategy that sacrificed Exxon and Chevron for the benefit of their index fund investors? Indeed, prioritizing the interests of index fund investors over other portfolios would likely doom those other businesses, as competitors would offer competing products that pledged loyalty to fund investors.

A trade-off strategy would also present a significant risk of fiduciary liability to clients.<sup>64</sup> As BlackRock explicitly says in its 10-K, “The Company is highly regulated and manages its clients’ assets as a fiduciary.” Just as corporate law incorporates a SFF in mandating that directors owe fiduciary duties to “their” corporation for the benefit of “their” corporation’s shareholders, so, too, trust law’s duty of loyalty has a similar, narrow, focus.<sup>65</sup> Under the traditional “sole interest” rule, a trustee must “administer the trust *solely* in the interest of the beneficiaries.”<sup>66</sup> As Schazenbach and Sitkoff point out,

Under this rule, “the trustee has a duty to the beneficiaries not to be influenced by the interest of any third person or by motives other than the accomplishment of the purposes of the trust.” “The trustee,” in other words, “is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person.” Acting with mixed motives triggers “an irrebuttable presumption of wrongdoing,” full stop.<sup>67</sup>

As they discuss in detail, “the ‘sole interest’ rule is mandatory under ERISA and is the default in trust law.”<sup>68</sup> But even the somewhat more permissive “best interest” standard applicable when the “sole interest” standard is waived – a standard roughly equivalent to corporate law’s “entire fairness” test – would not permit any trade-off strategy precisely because it involves sacrificing the interests of the beneficiaries for the benefit of some third party to that relationship.<sup>69</sup>

Given these fiduciary obligations, combined with business considerations, universal owners like BlackRock, Vanguard and State Street simply could not embrace a trade-off strategy of the sort suggested by Condon.

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<sup>61</sup> John Morley, Too Big to Be Activist, 92 S. Cal. L. Rev. 1407 (2019).

<sup>62</sup> <https://www.ishares.com/us/products/239507/ishares-us-energy-etf>

<sup>63</sup> <https://etfdb.com/etf/VDE/#holdings>; <https://investor.vanguard.com/etf/profile/portfolio/vde>

<sup>64</sup> Morley, *supra* note \_\_\_\_.

<sup>65</sup> Schazenbach and Sitkoff, Reconciling Fiduciary Duty and Social Conscience, 72 Stan. L. Rev. 381, 399-425 (2020).

<sup>66</sup> *Id.* at 400 citing 3 RESTATEMENT (THIRD) OF TRUSTS § 78(1) (emphasis added); see also UNIF. TRUST CODE § 802(a) (UNIF. LAW COMM’N 2000).

<sup>67</sup> *Id.* at 400-01, extensive citations omitted.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.* at 401-02.

### **c. Controlling Legal Risk**

The “enthusiastic” version of the hypo, analyzed above, is obviously highly unrealistic. In the real world, because of the substantial legal risk under both federal and state law, no one would proceed in such an explicit way. But that is part of our point: each step away from an explicit joint campaign comes at a price of effectiveness. Indeed, because of the clash between universal owners’ MFF and corporate law’s SFF, there will be nearly a direct relationship between how effective a strategy is for MFFs and how much legal risk it entails. Because the success of even the explicit MFF strategy is hardly assured – shareholders could easily vote down the BVS slate of directors, either because they had different financial interests or because they did not trust BVS’s directors to run the company well – more legally defensible (and less effective) approaches are unlikely to result in significantly lower carbon emissions.

First, BlackRock, Vanguard and State Street would never explicitly form a group because of the legal risks we describe above. In the real world, BlackRock, Vanguard and State Street do not nominate directors or coordinate (or even discuss) their positions at specific firms or run proxy contests. Instead, they allow others to launch proxy contests and then decide (independently) whether to support a slate in full or in part.

Second, because of corporate law’s SFF – in which all recognize that directors owe fiduciary duties to their corporation and not to their investors’ portfolios -- the campaigns that they will support will typically be framed in SFF terms.

Finally, at the fund family level, because of the differing interests of different funds, voting on issues that potentially affect different funds differently will often be pushed down to the fund level, with a fund’s portfolio manager casting the votes.

Each of these steps will make accomplishing the MFF outcome of Condon’s hypo less likely. Without coordinating with each other and with the other universal owners, coming up with a jointly acceptable MFF “low carbon” strategy will become far more difficult. Given the complexities of the calculation that Condon’s hypo demands, different investors will likely come to different conclusions and, without coordination, those different conclusions will result in different voting decisions.

Similarly, nominating or, more likely, supporting climate-concerned but independent board nominees will be far less effective than nominating a slate of candidates committed to a given low-carbon strategy, especially when that strategy sacrifices the interests of Exxon and Chevron for universal owners’ portfolio interests.

Further, the need to push decisions on potential trade-offs to the fund level will both reduce the universal owners’ voting power and make it less likely that they will support proposals that involve tradeoffs necessitating this more complex procedure.

### **d. What you may (or may not) get instead: Engine No. 1 at ExxonMobil**

As Condon discusses, ExxonMobil is an ideal target for climate-driven activism. As the largest publicly traded oil company, ExxonMobil’s products comprise a significant proportion of carbon emissions on both a current and historical basis. According to one study, ExxonMobil’s cumulative 1988-2015 share

of global industrial greenhouse gas emissions is 2.0%, while its emissions in 2015 were 1.4% of global totals.<sup>70</sup> Currently, Exxon is responsible for approximately 1.2% of annual global emissions.<sup>71</sup>

Moreover, ExxonMobil's financial performance over the last five years has been horrible in absolute and comparative terms. Total returns pre-Covid were -18.9% (1 year), -15.9% (3 year) and -17.5% (five years).<sup>72</sup> Comparatively, Exxon substantially trailed its peers over the same time periods: -12.5% (1 year); -31.7% (3 years); -45.2% (5 years). As an article in the Wall Street Journal put it in September 2020 when ExxonMobil was removed from the Dow Jones Industrial Index, "It has been a stunning fall from grace for Exxon Mobil Corp. Just seven years ago, ExxonMobil was the biggest U.S. company by market capitalization. It has since lost roughly 60% of its value, with its market cap now at around \$160 billion, after the pandemic crushed demand for fossil fuels."<sup>73</sup>

Making ExxonMobil even more vulnerable was a sense that it had not been listening to its biggest shareholders. BlackRock had singled out Exxon as moving too slowly to address climate risks, and in 2020 had voted against two ExxonMobil directors and in favor of separating the chair and CEO roles.<sup>74</sup> Already in 2017, BlackRock and Vanguard had both made it clear to ExxonMobil that it was moving too slowly in assessing climate risk.<sup>75</sup>

Against this backdrop, Engine No. 1, a newly formed hedge fund, launched a proxy contest to elect four directors at ExxonMobil's 2021 annual meeting. Engine No. 1's campaign was framed entirely in SFF terms.<sup>76</sup> In the summary slide, the investment thesis was simple: "The industry is evolving, and so must ExxonMobil," with four key elements (all quoted from Engine No. 1's PowerPoint presentation):

- ExxonMobil has significantly underperformed and has failed to adjust its strategy to enhance long-term value.
- A focus on chasing production growth over value has resulted in an undisciplined capital allocation strategy and has destroyed value even during periods of higher oil and gas prices.
- A refusal to accept that fossil fuel demand may decline in decades to come has led to a failure to take even initial steps towards evolution, and to obfuscating rather than addressing long-term business risk.
- A lack of successful and transformative energy experience on the Board has left ExxonMobil unprepared and threatens continued long-term value destruction.<sup>77</sup>

Having "diagnosed" the "problem," Engine No. 1 then made the case for its four board nominees. In the course of doing so, it explicitly disclaimed a trade-off strategy. As one slide pointed out, "Not just a

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<sup>70</sup> Paul Griffith, The Carbon Majors Report at Appendix I-II (pp. 14-15). Other estimates are higher. Friends of the Earth, Exxon's Climate Footprint at 5 (January 2004) (1882-2002: 5% of total emissions).

<sup>71</sup> Condon at 10.

<sup>72</sup> Exxon 2021 proxy statement at 51; Exxon 2020 Annual Report at 124.

<sup>73</sup> Christopher Matthews, Exxon's Bet on Oil, Gas Drags Down U.S. Titan, WSJ September 14, 2020 at A1.

<sup>74</sup> Christopher Matthews, Exxon vows to reduce its carbon footprint, WSJ December 15, 2020 at B1.

<sup>75</sup> Bradley Olson, Sarah Krouse and Sarah Kent, Big Investors Weigh Rebuking Exxon on Climate, WSJ May 26, 2017 at B5.

<sup>76</sup> Engine No. 1, Reenergize ExxonMobil//Investor Presentation (April 2021).

<sup>77</sup> Engine No. 1 ppt at 8.

climate issue – a valuation issue for all long-term investors.”<sup>78</sup> This theme continued as it focused on ExxonMobil’s “lack of capital allocation discipline,”<sup>79</sup> with a series of supporting points, including:

- Returns on upstream projects (~75% of capex) have been falling for years, even during times of higher prices.<sup>80</sup>
- Rising costs and falling capital productivity have fundamentally changed return profile.<sup>81</sup>
- ExxonMobil and peers are far more exposed to risk of declining demand than National Oil Companies (NOCs).
- ExxonMobil’s capital expenditures have outgrown cash generation, despite declining returns.
- Despite these dynamics, ExxonMobil has repeatedly committed to more aggressive spending than the industry.

Engine No. 1’s campaign was remarkably effective and three of their four nominees were elected. They received overwhelming support from the major index funds, most of the actively managed funds, the large state pension funds and both of the major proxy advisers (ISS and Glass Lewis).<sup>82</sup> Vanguard and State Street supported two of Engine No. 1’s four nominees, while BlackRock supported three.<sup>83</sup> CalPERS and CalSTRS publicly supported Engine No. 1 prior to the vote. Indeed, Aisha Mastagni, head of corporate engagement in CalSTRS’s sustainable investment and stewardship strategies unit, provided active support from the outset, coming close to jointly sponsoring the initiative.<sup>84</sup> Engine No. 1’s victory likely sends a signal that shareholders will not tolerate poorly performing management that ignores investors’ concerns with the risks posed by climate change. Certainly, this is how activist-defense advisors have interpreted the victory.<sup>85</sup>

But despite the fact that Engine No. 1’s campaign was framed in traditional single firm “total shareholder value” terms – ExxonMobil was undervalued because management was doing such a poor job managing the company during a period of rapid change in energy markets driven in part by climate change and the attendant risks – it could reflect a disguised example of Condon’s trade-off hypothetical. ExxonMobil tried to characterize it that way, with its “deck” accusing Engine No. 1 of being motivated by climate concerns rather than value concerns, as it claimed that Engine No. 1 had backpedaled from earlier positions that aggressively pushed for a reduction in oil and gas investment, increased investment in wind and solar, and a “wind-down” strategy.<sup>86</sup> And regardless of Engine No. 1’s intentions, diversified owners of ExxonMobil stock may have thought that electing Engine No. 1’s nominees could reduce Exxon’s carbon emissions with beneficial effects for their other portfolio

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<sup>78</sup> Id. at 23.

<sup>79</sup> Id. at 37.

<sup>80</sup> Id. at 38.

<sup>81</sup> Id. at 39.

<sup>82</sup> Evercore at 1,

<sup>83</sup> <https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-exxon-may-2021.pdf>

<sup>84</sup> Leslie Kaufman and Saijel Kishan, Calstrs’s crucial phone call eased path for activist’s Exxon win, Bloomberg June 18, 2021, available at <https://finance.yahoo.com/news/calstrs-crucial-phone-call-eased-090009091.html>

<sup>85</sup> Evercore, The New World of Shareholder (June 2021) on file with authors.

<sup>86</sup> ExxonMobil, Growing Shareholder Value in a Lower-Carbon Future (April 2021) at 68 available at <https://ir.exxonmobil.com/static-files/b4970581-bc73-409e-a658-49f05a369e25>



holdings. Thus, even if the Engine No. 1 strategy was framed as a SFF strategy, their nominees may have been elected by a coalition of MFF shareholders.

So is Engine No. 1's campaign at ExxonMobil a paradigm for a viable strategy to achieve the aims of Condon's hypothetical? Will activists conduct successful campaign that are nominally SFF but hold an MFF appeal to universal holders and that entail low legal risks?

Even if that is what happened at ExxonMobil – and we do not know that it is -- it is not clear that a similar approach would succeed in other companies, even ones with poor performance similar to ExxonMobil's. The shareholder base at ExxonMobil may have contributed to Engine No. 1's success, at least by reducing potential SFF opposition.

An investor's view of a tradeoff strategy like Condon's will depend, among other things, on the share of an investor's portfolio represented by the target firm. Condon's calculation assumes an investor that pursues an indexing strategy. Extending her analysis, an investor that is "overweight" will give greater weight to the effects on the target, and less to the benefits of reducing emissions, than an indexed investor. On the other hand, an investor that is "underweight" will give *less* weight to the effects on the target and *more* weight to the effects on the rest of its portfolio than an indexed investor. More generally, to a first approximation, investors that are overweight (underweight) will be more (less) SFF than investors that hold the market portfolio.<sup>87</sup> Because universal owners must create a winning coalition to implement a trade-off strategy, the composition of the shareholder base will be important.

In order to provide a sense of the intra-shareholder politics at Exxon, we looked at how the 30 largest Exxon shareholders voted, as well as their holdings as a percentage of Exxon and as a percentage of their overall portfolio. Due to the complex regulatory scheme that governs disclosure of investor ownership and voting, figuring out how the top thirty holders of ExxonMobil stock voted is a non-trivial task. Table 1 contains data prepared for us by Proxy Analytics LLC, a new firm that provides data analytics and consulting services on matters relating to ESG trends and shareholder voting practices.<sup>88</sup> Each year, Proxy Analytics captures and analyzes nearly 20M voting records that were gathered from SEC (Form N-PX) and web-based disclosures in order to generate profiles on how institutional investors vote. They then perform additional analytics to develop a deeper understanding of the factors that influence voting decisions. Information on beneficial holding and estimated voting authority was derived from quarterly 13F filings as of 3/31/2021 and then adjusted by Proxy Analytics using a proprietary methodology.<sup>89</sup> These investors together controlled about 34% of the vote in ExxonMobil.

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<sup>87</sup> Whether an investor is overweight or underweight in a given stock, without considering an investor's full portfolio, is an imperfect proxy for an investor's SFF v. MFF incentives.

<sup>88</sup> <https://www.proxy-analytics.com>.

<sup>89</sup> The record date for the shareholder vote was March 29, 2021. As of March 31, 2021, ExxonMobil constituted about 0.586% of the capitalization of all Russell 3000 companies. Column [ ] of the table then calculates, for each institutional investor, the ratio of the (x) percentage of the value of that holders 13F securities accounted for by ExxonMobil stock to (y) 0.586%. A ratio of above 1 would indicate that the holder is overweight is ExxonMobil stock; a ratio below 1 would indicate that the holder is underweight. Since 13F securities include securities beyond stock of the Russell 3000, these figures are likely to overstate somewhat the degree to which investors are overweight in ExxonMobil.

Table 1 also provides, for each holder, information on the value of ExxonMobil common stock as a percentage of the total value of the holder's 13F securities. This percentage reflects the extent to which a holder is invested in ExxonMobil relative to the market. For comparison, ExxonMobil stock at the time accounted for approximately 0.59% of the capitalization of the all the companies in the Russell 3000 index.

There are several notable features. First, among the 30 largest holders, many more seem to be underweight in ExxonMobil (relative to the Russell 3000 index) than overweight. Thus, for example, ExxonMobil stock represents more than 1.18% of the value of 13F securities (twice the Russell 3000 percentage) for only 2 holders, while it represents less than 0.29% (half the Russell 3000 percentage) for 4 holders. This is particularly noteworthy as being overweight in ExxonMobil would make it more likely for a holder to be included in the list of top 30 holders.

Table 1

Holder	Percentage Voting	Percentage Investment Power	Percentage of all 13F Securities	Vote
Vanguard	8.25%	8.25%	0.53%	Dissident
BlackRock	5.94%	6.68%	0.47%	Dissident
State Street	5.53%	5.85%	0.79%	Dissident
FMR	1.78%	2.01%	0.41%	Dissident
Geode Capital Management	1.49%	1.49%	0.54%	Management
Northern Trust	1.21%	1.21%	0.53%	Management
Norges Bank	0.92%	1.01%	0.58%	Management
State Farm	0.79%	0.79%	1.99%	No Information
Bank of New York Mellon	0.79%	1.28%	0.62%	Split
Franklin Resources	0.78%	0.83%	0.80%	Dissident
Charles Schwab	0.66%	0.66%	0.58%	Dissident
First Eagle	0.58%	0.61%	3.85%	Management
T Rowe Price	0.48%	0.48%	0.11%	Dissident
Capital World Investors	0.44%	0.44%	0.19%	Dissident
TIAA-CREF	0.43%	0.43%	0.32%	Dissident
Dimensional	0.41%	0.44%	0.35%	Dissident
Bank of America	0.39%	0.82%	0.22%	No Information
Swiss National Bank	0.38%	0.38%	0.61%	No Information
Sumitomo Mitsui	0.32%	0.32%	0.48%	No Information
PNC	0.29%	0.30%	0.84%	No Information
Amundi	0.29%	0.39%	0.71%	Dissident
Legal & General	0.26%	0.54%	0.47%	Dissident
CalPERS	0.23%	0.23%	0.41%	Dissident
APG Asset Management	0.21%	0.21%	0.71%	Dissident
Federated Hermes	0.21%	0.22%	1.01%	Dissident
AllianceBernstein	0.20%	0.21%	0.22%	Dissident
New York State Common Retirement Fund	0.18%	0.18%	0.48%	No Information
California State Teachers Retirement System	0.18%	0.18%	0.58%	Dissident
Fisher	0.17%	0.19%	0.32%	Dissident
Parametric	0.17%	0.22%	0.30%	Dissident

Second, the exposure to ExxonMobil is correlated with the vote of the holder. Thus, all of the four holders who voted for management nominees had a greater than median exposure to ExxonMobil stock. Money managers who are underweight in a company often have somewhat reduced incentives

to cast their votes to maximize the value of the company. While their direct fee income (a percentage of AUM) typically rises when the value of the company increases, such increases would also lead their funds to underperform their benchmark and other competing funds, potentially causing outflows and corresponding declines in assets under management. In extreme cases, underweight funds may even benefit when the value of the company declines (though this possibility is likely more theoretical than real).

By the same token, active institutional investors that are underweight at a company may be more attracted to a MFF strategy: Any losses at ExxonMobil from pursuing an MFF strategy would be mitigated, for these investors, by the fact that their performance relative to the benchmark would be enhanced if ExxonMobil lost value. The evidence in Table 1, while very limited, is consistent with the notion that Engine No. 1's campaign found more appeal with investors that had relatively low exposure to ExxonMobil.

This analysis of the shareholder base suggests that one possible explanation of Engine No. 1's success is that it appealed to investors with an MFF orientation without any strong opposition from investors with an SFF orientation. For what it is worth, Exxon stock price barely moved when the results of the proxy vote were announced, suggesting that shareholders did not believe that Engine No. 1's victory would lead to a decline in the stock price (and perhaps that Engine No. 1 was not pursuing a "trade-off" strategy). To the extent that universal owners perceived that electing the Engine No. 1 nominees to be at least not harmful to the value of Exxon, their decisions to support them would also have been relatively easy and, from a legal perspective, free of risk. By contrast, to the extent that they thought that electing the Engine No. 1 nominees would lead to a decline in Exxon's value, deciding how to vote would have been much more complex.

In other companies, however, where more active institutional shareholders are overweight in the company, an (explicit or implicit) MFF strategy may encounter more resistance and could be used to split apart a coalition of shareholders. For active managers, an MFF strategy that comes at the expense of a company in which the investor is overweight may be objectionable for two reasons. First, such a strategy is less likely to enhance overall portfolio value because the loss in the overweight company's stock is less likely to be outweighed by the gains in the rest of the portfolio than for an index investor. Second, even if the MFF trade-off strategy enhances overall portfolio value, it may lower their fund's relative performance and hence result in fund outflows. In those companies, an MFF trade-off strategy that requires the support of less diversified actively managed mutual funds will have even more difficulty assembling a winning coalition.

It is unclear to what extent ExxonMobil shareholders supported Engine No. 1's campaign for SFF or for MFF reasons. But even if the effect on other portfolio holdings was the reason why many holders of ExxonMobil voted for Engine No. 1's nominees, it is unclear whether Engine No. 1's success can easily be replicated at many companies. At companies in which the shareholder base tilts more strongly to less diversified investors, even a whiff of MFF may undermine the credibility of the activists and doom the campaign.

#### **e. Can Universal Owners Rely on an Intermediary?**

One response to the liability risks that arise out of the conflict between universal owners' MFF and corporate law's SFF might be to encourage the emergence of "intermediaries" that can further the collective interests of the universal owners without exposing them to legal liability. That is easier said than done.

Intermediaries in the corporate governance space have already emerged including the "Investors Forum"<sup>90</sup> and, on climate, "Climate Action 100+."<sup>91</sup> According to its website, "Climate Action 100+ is an investor-led initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change."<sup>92</sup> It claims that more than "570 investors, responsible for over \$54 trillion in assets under management" support their initiatives to engage with "companies on improving climate change governance, cutting emissions and strengthening climate-related financial disclosures." Climate Action 100+'s engagement strategy "is spearheaded by a lead investor or investors, who work cooperatively with a number of collaborating investors." Investors also engage on an individual basis but, when they do, are supposed to "liaise with relevant network staff and/or lead investors to ensure engagement priorities and ambition are aligned with the goals of the initiative, as well as with the overall collaborative approach (as appropriate in each sector)." Importantly, BlackRock, CalPERS, CalSTRS, JP Morgan Asset Management, and State Street are all members.

Climate Action 100+ makes three principal demands of companies: "clear commitments to cut emissions, improve governance and strengthen climate-related financial disclosures." The demands are justified on an MFF basis: "To mitigate investment exposure to climate risk and secure ongoing sustainable returns for their beneficiaries, investors are ensuring the businesses they own cut emissions to help achieve the goals of the Paris Agreement and accelerate the transition to net-zero emissions by 2050 or sooner."

Suppose that Climate Action 100+, concerned that the "supply response" described earlier threatens its carbon reduction strategy, targets *all* the major oil companies in the world, with several of its members spearheading the effort. In keeping with its approach, it strives to act as a coordinator of its members' actions, including their stewardship efforts, voting policies, lobbying and public relations. Suppose, further, that the multi-prong campaign is successful with the result that worldwide production of oil declines, and prices rise.

Two types of legal risk would immediately emerge. First, for U.S. targets, reporting under Schedule 13D would now be a real concern. Climate Action's website trumpets the cooperative nature of the engagements and their signatories' many successes. Moreover, the broad support of Climate Action members for the industry wide output reduction campaign would provide evidence that Climate Action and its members had formed a group for the purpose of voting, thereby triggering 13D disclosure obligations. While the website's disclaimer, echoing 13D, states that "Climate Action 100+ does not require or seek collective decision-making or action with respect to acquiring, holding, disposing and/or

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<sup>90</sup> <https://www.investorforum.org.uk/>

<sup>91</sup> [https://www.ceres.org/initiatives/climate-action-100?gclid=EAIaIQobChMI6YWfobSS8gIViJyzCh3z6gkeEAAAYASAAEgJm0vD\\_BwE](https://www.ceres.org/initiatives/climate-action-100?gclid=EAIaIQobChMI6YWfobSS8gIViJyzCh3z6gkeEAAAYASAAEgJm0vD_BwE).

<sup>92</sup> <https://www.climateaction100.org/about/>

voting of securities,” the facts (and Climate Action’s self-promotion) arguably would demonstrate otherwise.

Less obviously, the campaign could raise significant risks under Section 1 of the Sherman Act. An agreement to restrict output, like an agreement to fix prices, is a per se violation of Section 1 and exposes all members of the conspiracy to treble damages and criminal liability.<sup>93</sup> This is true whether the reduction in output is motivated by a desire to increase prices or for some other reason such as climate change.<sup>94</sup> One classic scenario in which an “agreement” is formed for the purpose of Section 1 is a trade association representative who organizes the members to work together.<sup>95</sup> One alternative description of the hypothetical Climate Action 100+ campaign is that Climate Action 100+ and its signatories were a “cartel ringmaster” that organized a production cartel (with a resulting increase in prices). Alternatively, one could describe the campaign as a “hub and spokes” conspiracy, with Climate 100+ and its members acting as the “hub” and the individual oil companies as the spokes. Under either description, the more effective the campaign – the greater the reduction in output -- the greater the participants’ legal risk. At the same time, because oil companies that reduced output in response to Climate Action’s pressure could likewise face liability under Section 1 as members of the conspiracy, the collective nature of the campaign could well *increase* companies’ resistance, as their lawyers warn them of the legal risks of any collective action to reduce output.

Like the “enthusiastic” version of Condon’s hypo, the legal risks created by an effective intermediary strategy make it unlikely that universal owners would embrace it. Were Climate Action 100+ to embark on such a strategy, the largest and best-advised universal owners would be well-advised to sever their connections.

#### **f. The Softer Forms of Activism: Shareholder Proposals**

Engine No. 1’s campaign at ExxonMobil was unprecedented and it is too early to tell how many similar campaigns will succeed. More common are the climate-related shareholder proposals and engagement meetings.

During the 2020 proxy season, climate related shareholder proposals did very well. Of the 14 proposals primarily focused on climate change that reached a vote, three received majority support, including one at Chevron.<sup>96</sup> An additional two related proposals received majority support, including a proposal at Phillips 66. Both Chevron and Phillips 66 were targeted by Climate Action 100+ which has taken a leading role. [update/supplement when the Georgeson 2021 report comes out]: Climate related

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<sup>93</sup> For an extensive discussion of the possibility that shareholder organized industry wide agreements create potential liability under Section 1, see Edward Rock and Daniel Rubinfeld, Common Ownership and Coordinated Effects, 83 Antitrust L. J. 201 (2020).

<sup>94</sup> For an important discussion of the extent to which existing antitrust doctrine constrains corporations’ pro-social collaboration, see Amelia Miazad, Prosocial Antitrust, 73 UC Hastings L. Rev. – (forthcoming 2021).

<sup>95</sup> The classic example is Am. Column & Lumber Co. v. United States, 257 U.S. 377 (1921). Another clear example comes from a recent case from the EU involving a management consultant whose specialty seems to have been organizing cartels. Case C-194/14 P, AC-Treuhand AG v. Comm’n (CJ 2015), ECLI:EU:C:2015:717.

<sup>96</sup> Georgeson 2020 annual report at 34.

shareholder proposals continued to garner substantial support during the 2021 proxy season. [INSERT DATA].

While Climate Action 100+, as we discuss above, takes an explicitly MFF, BlackRock, by contrast, frames its engagement priorities and expectations with a SFF.<sup>97</sup> Between the lines, however, BlackRock may well be motivated by MFF concerns. Thus, BlackRock

expects companies to have clear policies and action plans to manage climate risks and to realize opportunities presented by the global energy transition. Investors and other stakeholders will look at companies' disclosures to analyze how climate risk is integrated into their long-term strategies and evaluate their preparedness for a transition to a low-carbon economy.

BlackRock's expectation that firms integrate climate risk into their strategies and be prepared for a transition to a low-carbon economy are justifiable from an SFF perspective. But the fact that these expectations would be likely to push companies into reducing their reliance on carbon fuels and hence promote MFF may not be entirely coincidental. As a case in point, there are surely many business strategies that would enhance firm value but entail (legally permissible) climate damage, and BlackRock has no equivalent expectations that firms explore these strategies.

MFF concerns are even more apparent when we turn to some of the details. Specifically, when it comes to emissions, BlackRock is quite demanding:

Specifically, we expect companies to disclose scope 1 and scope 2 emissions and accompanying GHG reduction targets. Companies in carbon-intensive industries should also disclose scope 3 emissions. A significant portion of the transition to a low-carbon economy hinges on the eventual retirement of fossil fuels, and it is particularly important for investors to understand the scope 3 emissions profile of oil, gas, and coal companies as the primary source of fuel transitions from carbon-intensive solutions to cleaner alternatives. The viability of these fuel sources will also become diminished as companies within the transportation and energy value chain, such as original equipment manufacturers, auto-makers, and utilities, accelerate the design of battery, electric, and hydrogen powertrains to further mitigate emissions and prioritize clean energy use.

Increased disclosure on emissions can always be justified as aiding investors' ability to price securities. But what about "GHG reduction targets" which, the statement implies, are desirable for all companies? At least some companies may find it in their interests to *increase* emissions (within legal limits). If fossil fuels will be regulated out of the energy sector, oil companies, for example, may well want to increase production now before their reserves become valueless and coal-fired power plant operators would not want to upgrade their soon-to-be-mothballed facilities by installing filters.<sup>98</sup> While BlackRock never says outright that it favors emission targets even if they reduce profits of the company setting the targets, and while its statements are vague enough for BlackRock to walk away from this implication, its references to GHG emission targets is much more compatible with an MFF than a SFF.

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<sup>97</sup> <https://www.blackrock.com/corporate/about-us/investment-stewardship>

<sup>98</sup> <https://www.power-technology.com/features/feature104857/>

BlackRock's memo on "Climate risk and the transition to a low-carbon economy" is consistent with this interpretation. There BlackRock explain that:

Underlying our desire for greater disclosure on emissions baselines, GHG reduction targets, and transition plans, is our conviction that climate risk is investment risk. Solutions to climate change and the transition to a low carbon economy require concerted effort on the part of companies, including assessing their operations and adapting their businesses to remain resilient.

It would often be entirely legitimate for BlackRock to take a portfolio perspective given BlackRock's duties to its clients with diversified portfolios "to deliver sustainable long-term financial returns." From a portfolio perspective, obtaining information on emissions and transition plans that help BlackRock to evaluate how much a climate risk is entailed by a particular investment, and even pushing companies to reduce their exposure to climate risk is sensible and consistent with an SFF.<sup>99</sup> But again, GHG reduction targets would seem to affect climate risk principally by lowering the climate-based *negative externalities* generated by emissions, rather than the climate risk facing the emitting firm. Favoring GHG reduction targets because of a concern with climate risk -- rather than, e.g., because reducing emissions is a good strategy for fending off more onerous regulation -- thus indicates an MFF orientation.

BlackRock and other shareholders in voting on shareholder resolution are, of course, free to take an MFF perspective. Indeed, as investment fiduciaries, they may even be required to do so. Moreover, as we have discussed, shareholders are privileged to cast votes in their self-interest, an interest that includes extraneous matters such as other portfolio holdings or a public-spirited commitment to fight climate change. The problem is that the board has a different set of duties and, under directors' duty of loyalty, must consider whether the actions proposed by a resolution are in the best interest of the company.

BlackRock and other shareholders may also take an MFF perspective in their engagement meetings with a company's directors and executives. But urging a board in such meetings to take actions that are in the shareholders' extraneous interest, but not in the company's interest, carries a somewhat higher legal risk than a mere vote in favor of a precatory resolution. At some point, if directors heed these demands, the shareholder may be exposed to claims for aiding and abetting a breach of fiduciary duties.

Indeed, whatever BlackRock proclaims in its public materials, we do not know what BlackRock says to board members and executives in engagement meetings. BlackRock may spend little time discussing emissions, focus on disclosure rather than GHG reduction targets, or push for targets only in situations where targets can be justified as enhancing firm value. BlackRock is well aware that the board has a fiduciary duty to act in the best interest of the corporation, and we doubt that BlackRock would ask the board in its engagement meeting to take an action that reduces company value in order to enhance the value of other portfolio securities owned by BlackRock and other shareholders.

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<sup>99</sup> It would be consistent with an SFF since market participants may generally be concerned about the amount of systematic risk (including climate risk that is systematic) a particular investment contributes to a portfolio and since therefore a reduction in risk may increase the value of a company. Brealey & Myers.



Thus, both shareholder resolutions and engagement meetings contain a trade-off: the more openly one advocates for board action on an MFF basis, the more risk is created that a board will violate its fiduciary duties if it undertakes the action. Thus, we would expect BlackRock to at least pretend that the course it advocates benefits the company. Just as BlackRock understands the fiduciary duty constraints under which the board is operating, the board understands that BlackRock has substantial extraneous interests. While the board may thus be skeptical of BlackRock's SFF arguments, it also has an interest in maintaining good relationships with its large shareholders. If both BlackRock and the board can maintain the facade that the objective is to maximize company value, the board is more likely to heed BlackRock's requests.

The recent ExxonMobil vote provides some evidence of such a kabuki theatre. In addition to voting on the contested director election, shareholders were asked to vote on a proposal by BNP Paribas Asset Management that asked the company to issue a report within the next year "describing if, and how, ExxonMobil's lobbying activities (direct and through trade associations) align with the goal of limiting average global warming to well below 2 degrees Celsius (the Paris Climate Agreement's goal)."<sup>100</sup> The main purpose of this proposal, we would guess, was to induce ExxonMobil to stop lobbying against the Paris Climate Agreement, with the ultimate goal of facilitating implementation of the accord for the benefit of the public and the benefit of other companies (albeit not for ExxonMobil's benefit). But BlackRock, which supported the proposal, explained that it was concerned about "the reputational risk to the company of misalignment in public positions on key strategic policy issues" – a pure SFF rationale for the vote.<sup>101</sup> Indeed, the BNP Paribas proposal also asked the company to assess "the risks presented by any misaligned lobbying and the company's plans, if any, to mitigate these risks" – an addition that gave some surface plausibility to BlackRock's explanation.

In short, one can interpret many of BlackRock's statements and actions as promoting MFF under the cloak of SFF. While expressed in terms of a SFF, BlackRock's goal, we surmise, is at least partially based on a MFF because, as a sophisticated universal owner, any other strategy would be irrational. But the need to articulate a plausible SFF basis for proposals, even if these proposals are truly meant to further MFF goals, places significant constraints on universal holders. Returning to Condon's hypothetical, we do not think that it is possible for a universal owner to make a sufficiently plausible case that it is in Exxon's interest to cut its emission by 40% when doing so would result in 20% drop in Exxon's value.

#### **IV. Can Corporate Law's SFF be Changed to promote a MFF?**

As discussed above, there is an intriguing case for robust systemic stewardship of the type proposed by Madison Condon and Rick Alexander. Universal owners have better incentives than anyone else to pursue policies that force the internalization of carbon externalities even (or especially) when doing so requires sacrificing a small number of highly polluting companies for the benefit of the overall portfolio (and society). If current corporate law and practice interfere with pursuing these economically and

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<sup>100</sup> WLRK memo, July 22, 2021

<sup>101</sup> Id.

socially rational goals, then perhaps corporate law and practice should change.<sup>102</sup> Is doing so politically plausible?

We think the answer is no. While there would be powerful political forces and interests that may favor a move to an MFF approach – universal owners, individuals and groups concerned about climate change and environmental damage – an MFF approach remains a second-best to direct governmental regulation. Direct governmental regulation would be more beneficial for the environment as it would apply not just to publicly traded companies with diversified shareholders but also to other business entities. As a result of the broader scope, direct governmental regulation would also reduce the risk of a competitive response that would reduce or eliminate the benefits from actions by individual companies. Indeed, adopting an effective MFF approach for public companies without direct regulation will, over time, lead to a change in industry composition from public to private companies, especially in industries such as energy that would be the prime targets of an MFF approach. Thus, the longer-term benefits from a MFF approach would be limited.<sup>103</sup>

Second, a move to a MFF would also garner substantial opposition. Employees and managers of carbon emitting firms that would be sacrificed under such an approach would stand to lose a lot and would likely be strongly opposed. The media responses to Engine No.1's SFF campaign provide a taste of what an explicit "trade-off" campaign would attract. In an editorial immediately after the ExxonMobil shareholders meeting, the Wall Street Journal viewed Engine No. 1's victory as "a reflection of the enormous political pressure and financial leverage of government pension funds, proxy advisers and asset managers like BlackRock that want to be seen as virtuous to the progressives who are now in power."<sup>104</sup> Moreover, the WSJ characterized the campaign's goal: "Make the biggest U.S. oil and gas company 'transition' out of its legacy business." WSJ columnist Holman Jenkins, Jr., was similarly unimpressed: "When you've failed to convince consumers to stop consuming oil, when you've failed to sway politicians to ban or even disincentivize its production, that's when you go to oil company boards and insist that they voluntarily refrain from producing a legal product for which there is huge and inelastic demand."<sup>105</sup>

Third, an MFF approach has other potential adverse collateral consequences. As has been pointed out, empowering universal owners to cooperate for privately and socially beneficial goals like reduction in carbon emissions can also empower them to cooperate for privately beneficial but socially harmful goals like raising airline ticket prices.<sup>106</sup> Whether common ownership has already resulted in anti-competitive effects is the subject of an on-going debate, but there is wide agreement over the possibility that a MFF can in principle produce anti-competitive effects.<sup>107</sup>

Corporate law is state law, so any change would typically be expected to begin with the states. Shifting to an MFF approach would not appeal to Delaware, the most important corporate law jurisdiction, given

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<sup>102</sup> See Armour and Gordon, Systemic Harms and Shareholder Value, at 50-56, *supra* note \_\_\_\_.

<sup>103</sup> An MFF approach that did not affect private companies would also generate less political opposition than direct governmental regulation. But because an MFF approach is less effective due to competitive responses and shift in industry composition, it is likely to have a stronger effects on the degree of support than to the degree of opposition.

<sup>104</sup> The Proxy Coup at Exxon, WSJ May 26, 2021.

<sup>105</sup> Holman Jenkins, Jr., The Climate Yawns at Exxon "Coup", WSJ June 2, 2021 at A13.

<sup>106</sup> CITE to Schmalz?

<sup>107</sup> CITE to Salop?

the extent to which a SFF is fundamental to the deep structure of Delaware corporate law. As discussed above, shifting to a MFF would require a wholesale re-configuration of corporate law. The prospect that doing so would intellectually appeal to Delaware's judiciary or bar are remote. Delaware's corporate law, of course, is also shaped by Delaware's economic interests: the interests of the Delaware fisc in incorporation fees from Delaware companies and interests by the Delaware bar in revenues from representing Delaware companies and litigation Delaware courts. From these perspectives, Delaware has an interest in satisfying directors and shareholders, who jointly control where companies incorporate.

But is this too pessimistic? While managers would tend to be opposed to shifting to an MFF, shareholders would be split with the large and growing segment of highly diversified universal owners favoring an MFF. But looking at the interests of current shareholders and managers is too narrow an approach. Delaware cares not only about the where the existing stock of public corporations is domiciled but also about how attractive it is to become – and remain – a public corporation. Facilitating an MFF would make it relatively less appealing to be a publicly traded company (under pressure to sacrifice its profits for the good of others) than a privately held company (which will face no such pressure, but still be able to free-ride on sacrifices of others).<sup>108</sup>

Finally, were Delaware to shift to an MFF, some other state, intent on getting a slice of the incorporation business, could offer a commitment of SFF as a differentiated product. Public companies, at the IPO stage or when still held by undiversified owners, could incorporate in such a state with provisions (such as high voting requirements) that would it difficult to reincorporate in to Delaware once its shareholder profile changes and it becomes dominated by universal shareholders

Pursuing a shift to MFF at the federal level would not have any greater chance of success. In light of the strenuous opposition that a shift to MFF would engender, and the superiority of dealing with environmental and risk-based externalities through direct regulation, any coalition that stood a chance of succeeding would prefer to put its efforts into direct regulation. Moreover, the fact that corporate law is traditionally state law would provide another argument in favor of devoting efforts to direct regulation.

We thus see very little chance that corporate law's deep seated SFF will be changed, however strenuously supporters of an MFF will push.

## **Conclusion**

In the face of the arguments for systemic stewardship, it is worth reviewing the normative foundations for the traditional single firm focus that is so deeply entrenched in corporate law, and that poses substantial obstacles to systemic stewardship with trade-offs.

The traditional defense of a SFF and, within that, a focus on shareholder value, is that it ultimately leads to greater social welfare. This traditional approach assumes adequate regulation: effective antitrust to

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<sup>108</sup> Similarly, if Delaware adopted an MFF, some other state, intent on getting a slice of the incorporation business, could offer as a differentiated product a commitment to SFF. Public companies, at the IPO stage or when still held by undiversified owners, could incorporate in such a state with provisions (such as high voting requirements) that would it difficult to reincorporate in to Delaware once it shareholder profile changes and it becomes dominated by universal shareholders.

maintain competitive markets; environmental regulation to force the internalization of externalities; employment law to protect workers; etc. With that assumption, corporate managers face a constrained optimization task: maximize firm value consistent with meeting regulatory obligations. Within this framework, corporate law has a narrow scope: create the corporate form; define its terms and ground rules; and constrain agency costs.

When markets are competitive and other areas of the law carry out their missions, maximizing single firm value will benefit shareholders and increase social welfare. On the other hand, under conditions of monopoly, shareholders may not agree on single firm profit maximization because they have heterogeneous interests.<sup>109</sup> This implies that one cannot simultaneously achieve: complete portfolio diversification; management that implements shareholders' preferences; and competitive markets.<sup>110</sup>

Even in a world of substantial portfolio diversification, the advantages of this traditional framework are many. First, by fixing the goal at SFF, it avoids the instability and indeterminacy that heterogeneous shareholder interests can produce, with a benefit to competition. Second, corporate governance's narrow lane avoids confrontation with political forces. Firms need not take any position on social policy and need not engage in social and political tradeoffs. Third, the narrow focus promotes accountability of management to shareholders.

The push for *systemic* stewardship starts with a critique of the traditional model. In fact, proponents argue, other areas of the law do not carry out their missions: financial regulation does not adequately control systemic financial risk; antitrust law does not adequately protect competition; environmental law does not force the internalization of the social cost of carbon; employment law does not adequately protect employees. Moreover, political dysfunction in the face of climate change threatens investors' entire portfolios (and life on the planet) and creates an imperative to respond.

From this perspective, systemic stewardship is a clear second best to well-implemented SFF. The substantial political obstacles to changing the status quo, outlined above, raise fundamental questions. If there is the political will to change corporate law's SFF to permit universal owners to intervene to address climate change risk on a portfolio basis, why isn't there sufficient political will to enact a carbon tax or some other regulatory intervention to force internalization? Absent political will to control or mitigate climate change, how will universal owners pursuing MFF have any material welfare effect?

On the other hand, an optimist might note, getting universal owners – among the most powerful forces in the capital markets – to take climate change seriously enough to change their corporate governance strategies may be the most effective way to develop the broad political consensus necessary to enact adequate regulation. This could be true in two different ways. First, if elites become convinced that climate change poses an existential threat, they may succeed in convincing governments to act. From this perspective, a variety of environmental initiatives -- from recycling to electric vehicles to carbon offsets -- may be important even if they do not, in fact, reduce emissions, energy use or waste or achieve any of the other stated goals.

Second, inducing change at a firm level, even (or perhaps especially) if it engenders a competitive response, may transform the political landscape in important ways that could be far more important

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<sup>109</sup> Jose Azar, The Common Ownership Trilemma 87 U. Chi. L. Rev. 263, 273 (2020).

<sup>110</sup> Id.

than the direct economic effect. Suppose that, under shareholder pressure, Exxon and Chevron are forced to factor in the social cost of carbon in their exploration and production decisions, with the result that their production drops substantially along with their stock price while competitors pump more oil. This would give Exxon and Chevron a strong incentive to lobby Congress to enact legislation that would force their competitors to do the same thing. Indeed, because it is hard to imagine a more significant change in the political landscape than Exxon and Chevron becoming active supporters of, e.g., a carbon tax. The recent embrace of a carbon tax by the American Petroleum Institute provides some evidence that this process is already underway.<sup>111</sup> The best defense of systemic stewardship may be as a catalyst for political change.

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<sup>111</sup> <https://www.api.org/news-policy-and-issues/news/2021/03/24/climate-action-framework> (March 25, 2021).