Systematic Stewardship: It's Up to the Shareholders

A Response to Profs. Kahan and Rock

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As the author of an article entitled "Systematic Stewardship,"[1] I read Professors Kahan and Rock's article "Systemic Stewardship with Tradeoffs" (K&R)[2] with considerable interest. I acknowledge the limits on deep asset manager engagement with sources of systematic risk in light of present institutional arrangements and the politics of the moment. Yet I think the most important move in the K&R analysis—the privileging of a "single firm focus" in corporate law instead of a "portfolio firm focus"—simply doesn't account for the evolution that has already occurred in law and practice.

Long before the development of index funds, the ownership of public firms has been characterized by a division between diversified and undiversified owners.[3] The interests of these shareholders are not uniform. One particularly important kind of undiversified owner is a controller. Courts have permitted significant accommodation to the interests of controllers.[4] Although blatantly redistributive measures are not permitted, e.g., *Hollinger International v. Black*,[5] the law commonly permits controllers to obtain various pecuniary and non-pecuniary benefits in a way that is inconsistent with the demands of single-firm-focus as K&R describe them. If directors can run the firm to accommodate the interests of one class of investors, the controllers, for their particular benefit, why would it not be permissible to accommodate the interests of another class of investors, the fully-diversified?

Two famous cases are illustrative: in *Sinclair Oil Corp. v. Levien*[6] the parent Sinclair, which had a majority interest in a profitable subsidiary, used its control to cause the subsidiary to pay out dividends that the parent used to exploit oil exploration opportunities that the subsidiary would otherwise have pursued but now found itself cash poor.[7] Because the dividends were paid out pro-rata and otherwise conformed to the dividend payout

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1. *See generally* Jeffrey N. Gordon, *Systematic Stewardship*, 47 J. CORP. L. 627 (2022).
2. Marcel Kahan & Edward Rock, *Systemic Stewardship with Tradeoffs*, 48 J. CORP. L. 497 (2023).
3. *See generally* Matthew Backus, Christopher Conlon & Michael Sinkinson, *Common Ownership in America: 1980–2017*, 13 AM. ECON. J. 273 (2021) (assessing common ownership and diversification using S&P 500 data from 1980 to 2017).
4. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785–95 (2003) (showing judicial sanction for a permissible level of private benefits of control in various settings).
5. *See* Hollinger Int'l v. Black, 844 A.2d 1022 (Del. Ch. 2004) (Strine, V.C.) (highlighting how a controller's use of a pyramid structure and dual class common stock to extract private benefits is impermissible and was the basis for board's acting in opposition to desires of controller).
6. *See generally* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).
7. *Id.* at 720–23.

statutes, the Delaware Supreme Court held that this use of control was not "self-dealing."[8] Thus "business judgment," not "intrinsic fairness," was the appropriate standard of review and the dividend payout passed.[9] The importance is this: the directors of the subsidiary were deemed to have acted permissibly even though their action favored the interests of the parent over those of the subsidiary's public shareholders. The controller was able to pursue a vision of value maximization that was hardly "single firm focused" from the perspective of the subsidiary. The optimistic case is that the parent pursued an overall investment strategy that optimized for the combined business group, the portfolio of Sinclair-controlled firms, but even that was not required.

Another example is *Mendel v. Carroll.*[10] The controlling Carroll family initiated a take-private transaction of Katy Industries at a price negotiated with a special committee.[11] Along came a third-party bidder that offered a higher price to the public shareholders and, when the controllers refused to sell at that price, pushed the board to include an option that would dilute the controllers' blocking position.[12] Chancellor Allen held that the controllers had no duty to sell at the public shareholder price and that the board would be wrong to undermine the majority's blocking position.[13] This is another case in which a board can (and here, should) act for the benefit of one group of shareholders even at the cost to another.

The ultimate justification for judicial acquiescence in this deviation from a "single firm focus" is articulated in a relatively recent landmark Delaware case, *Corwin v. KKR Financial Holdings LLC.*[14] The company, which arranged financing for various KKR buyouts, had delegated virtually all management functions to KKR, which held less than one percent of the company's stock.[15] KKR subsequently negotiated a stock-for-stock merger with this captive entity.[16] In justifying why "entire fairness" should not apply in challenge to the merger terms, the Delaware Supreme Court endorsed the idea that this dependence "w[as] known at all relevant times by investors" and "the stockholders cannot claim to be surprised."[17] The explanation certainly suffices to justify why the shareholders of the Sinclair subsidiary should not be surprised by the directors' timing a dividend payout

8. *Id.* at 720–22.

9. *Id.* at 720.

10. Mendel v. Carroll, 651 A.2d 297 (Del. Ch. 1994).

11. *Id.* at 300–03.

12. *Id.* at 302.

13. *See also In re* Books-A-Million, Inc. S'holders Litig., No. CV 11343-VCL, 2016 WL 5874974, at *8 (Del. Ch. Oct. 10, 2016), *aff'd on basis of opinion below*, 164 A.3d 56 (2017) (holding that, in a take-private bid, the controller can both refuse a competitive offer for a higher price than the controller is offering public shareholders and then proceed with its own offer, if approved pursuant to procedures set forth in *Kahn v. M&F Worldwide*, 88 A.3d 635 (Del. 2014)); Smart Loc. Unions & Councils Pension Fund v. BridgeBio Pharma, Inc., No. 2021-1030-PAF, 2022 WL 17986515, at *11 (Del. Ch. Dec. 29, 2022) (same). In light of these recent cases, it is puzzling to see the reliance K&R place on a frankly obscure case of 100 years ago, *Allied Chemical & Dye Corp. v. Steel & Tube Co. of America*, 120 A. 486 (Del. Ch. 1923), a case whose holding was substantially narrowed in *Cottrell v. Pawcatuck Co.*, 128 A.2d 225 (Del. 1956).

14. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304 (Del. 2015) (Strine, C.J.). The control oddity arose from the fact that the issuer had entered a contract that delegated all management function to a one percent shareholder. *Id.* at 306.

15. *Id.* at 306.

16. *Id.*

17. *Id.* at 306–07.

to meet the controller's objectives, or the Carroll family's preference for continued family ownership or, more generally, that controllers appoint family members to key executive positions or may pursue a kind of benevolent paternalism that satisfies their non-pecuniary goals. And surely today every public investor knows of the ownership structure of most large public companies and thus could not be "surprised" by accommodation to these majoritarian owners.

Let's generalize the argument. The governance of public companies today is shaped by portfolio investors who are trying to maximize the value of the portfolio even if particular firms within the portfolio are thereby made less valuable from the perspective of undiversified investors. Moreover, the operations and strategy of public companies are in many respects shaped by the interests of portfolio investors without regard to the likely negative consequences for undiversified investors. But this is not a problem because these facts are "known at all relevant times by investors."[18] What we learn from the controller cases is that the corporate law, including the fiduciary duty of directors, accommodates itself to the facts of ownership. Where portfolio investors are the majoritarian owners, it is entirely conventional for boards to take their interests into account.

Turning to some specific demonstrations of these propositions: As I noted in my original article: "we have accepted virtually without question that a portfolio investor can use shareholder rights to promote a corporate governance regime that may indeed promote the value of portfolio firms on average—and thus increase the value of its portfolio—but will not necessarily be well-tailored for every firm."[19] The most salient example is the systematic pressure to declassify corporate boards using threats to "vote no" on management director nominees. This tool was enhanced by pressure from portfolio investors for firms across their portfolio to adopt majority, not plurality, voting rules for the election of directors. Yet there is considerable evidence, for example, the natural experiment provided by the Massachusetts statute mandating board classification and the widespread adoption of board classification in high-tech IPOs, suggesting that for at least some firms, board classification would be the optimal governance arrangement.[20] More generally, asset managers and other portfolio investors have developed a series of corporate governance "best practice" guidelines that they believe will increase expected returns across their portfolios, irrespective of the costs for particular firms for which more tailored regimes would increase own-firm values. They adopt guidelines rather than engage in firm-specific analysis to economize on asset management costs in the quest for their private competitive success; an "agency cost of agency capitalism."[21] Tailoring is too expensive for such portfolio investors and the gains are generally idiosyncratic (meaning: of little value to a diversified investor). In short, the interests of undiversified shareholders in those firms are traded against the interests of portfolio investors.

As I also noted in my original article, "[w]e have also accepted without question allowing the risk preferences of diversified investors to shape our theory of optimal firm

18. *Id.* at 306.

19. Gordon, *supra* note 1, at 667.

20. Robert Daines, Shelley Xin Li & Charles C.Y. Yang, *Can Staggered Boards Improve Value? Causal Evidence from Massachusetts*, 38 CONTEMP. ACCT. RSCH. 3053, 3080 (2021).

21. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Re-valuation of Governance Rights*, 113 COLUM. L. REV. 863, 867 (2013) (analyzing research concerning IPO performance in Massachusetts).

structure in a way that has firm-specific consequences."[22] Diversification at the portfolio level means that such shareholders disfavor diversification at the firm level, biasing the firm against conglomeration and other diversification measures that may reduce the financial distress risk at the own-firm level and may thus increase costs for the undiversified shareholders. Diversified investors encourage risk taking at the firm level to maximize own-firm expected returns, despite the greater own-firm solvency risks, on the view that this strategy will increase expected returns across the portfolio. As part of this approach to risk, diversified investors push for cash distributions despite the increased own-firm risks. Portfolio investors are not mere kibitzers with talking points; their support is a crucial factor in the success of hedge fund activists who commonly push these strategies on target firms.[23] The say-on-pay mechanism is another vehicle by which portfolio investors promote the pursuit of a particular strategy of maximization.

Indeed, a portfolio approach is embedded at the core of "shareholder wealth maximization," as it is commonly understood, in light of how portfolio theory is critically involved in stock price formation. Modern Portfolio Theory holds that investors are compensated for bearing risk, but only for risk that cannot be diversified away.[24] This is operationalized through specific pricing models like the well-known "Capital Asset Pricing Model" ("CAPM"). Thus, market prices of specific securities are set on the assumption that investors are holding such shares in a well-diversified portfolio. Firms trying to "maximize shareholder value" will avoid unrelated diversification, the effect of which may be to reduce own-firm risk but at cost of local inefficiencies in managing a conglomerate enterprise, resulting in a stock price penalty. This follows from a price formation process that assumes idiosyncratic risk can be substantially eliminated through portfolio diversification. More generally, when managers are trying to "maximize shareholder value" for a widely held public company they cannot escape the portfolio structure of share ownership.

In short, what may serve the interests of portfolio investors will often disserve the interests of the undiversified. In this important respect, there is no such thing as a "single firm focus."[25] Rather, at most it is what could be described as a "single firm focus constrained by awareness that the majoritarian shareholders are portfolio investors, and their interests are best served by a firm strategy that in significant respects takes that fact into account."

Now we turn to externalities. To borrow from a case developed in the original article:[26] Suppose a chemical company operated a high-polluting (but lawful) plant; its effluents caused a particular level of health harms in surrounding communities. An environmental activist fund runs a proxy contest to install a board that would substitute a lower-polluting plant whose financing and operations would result in a lower level of

22. Gordon, *supra* note 1, at 667.

23. *See* Anna L. Christie, *The New Hedge Fund Activism: Activist Directors and the Market for Corporate Quasi-Control*, 19 J. CORP. L. STUD. 1, 9 (2019) (discussing how institutional investor support—i.e., portfolio investors—are a necessary component to a hedge fund activist's success).

24. *See generally* RICHARD A. BREALEY ET AL., *Ch 8.1–8.3, Portfolio Theory and the Capital Asset Pricing Model*, *in* PRINCIPLES OF CORPORATE FINANCE, 198, 198–213 (13th ed. 2020); RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, 101, 101–34 (2d ed. 1995).

25. Kahan & Rock, *supra* note 2, at 500.

26. Gordon, *supra* note 1, at 669.

profitability. The activist wins with the support of institutional investors and replaces the "dirty" plant with a "clean" one at the as-predicted cost to profitability. Is it really the K&R position that other shareholders could succeed in a Delaware derivative suit against the board and the institutional investors? I think the business judgment rule offers ample protection to directors who chose to operate the firm so as to avoid externalities and would similarly regard the board's definition of what counted as an "externality" as also within the scope of the business judgment rule.

But K&R might say, this kind of externality avoidance or reduction is consistent with traditional ideas of "single firm focus" because the benefits are generated for the "community," which would be included within the set of the firm's stakeholders. Such actions have traditionally been defended in own-firm terms—for example, protecting the firm's reputation. It would be rare for portfolio investors particularly to benefit from this kind of externality avoidance for the immediate community.

What about systematic externalities? Lehman Brothers and similar firms present the testing case. Suppose portfolio investors support insurgents whose stated purpose in getting board seats is to reduce risk-taking by this systematically important firm on the view that the costs of failure are disproportionately borne by portfolio investors? The own-firm expected returns from risk-taking may be high, and the downside is capped at the undiversified shareholder's ownership stake in the own-firm. Yet a portfolio investor will suffer massive losses from the failure of a systemically important firm and therefore might be regarded as receiving disproportionate benefits from board action that restrains such risk-taking. Indeed, the portfolio investors might operate directly to reduce such risk-taking by using say-on-pay votes to anathematize pay packages with high pay-for-own-firm performance incentives. Notice this is a case in which own-firm profitability is restricted precisely to serve the economic objectives of the portfolio investors, the majoritarian owners of the firm. Do K&R really want to say that shareholders have no legitimate role in trying to restrain risk-taking by systemically important financial firms? That it is all up to the Fed's rule setting and supervision as to whether we can avoid financial catastrophe?

I think the doctrinal logic applies to portfolio investor engagement with climate change as well.

There is an additional doctrinal hook: the board's prerogative of assessing the time frame over which it will measure the pursuit of "shareholder value," in K&R single-firm-focus terms.[27] A board could rationally believe that immediate concerted action is necessary to avoid a looming climate catastrophe that would swamp the own-firm itself. The risks of climate change are not necessarily linear; climate scientists are concerned that these risks may manifest themselves in catastrophic ways: for example, the reversing of a critical ocean current[28] or an abrupt rise in sea level from the sliding into the ocean of a

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27. *See* Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1990) (holding that it is the prerogative of directors to set the time for the corporation's "best interests without regard to a fixed investment horizon").

28. *See* Peter Ditlevsen & Susanne Ditlevsen, *Warning of Forthcoming Collapse of the Atlantic Meridional Overturning Circulation*, 14 NATURE COMMC'NS 1, 6 (2023), https://doi.org/10.1038/s41467-023-39810-w [https://perma.cc/27J4-PGBH] (stating the time estimate of the tipping point of collapse of the Atlantic ocean current is 2050, 95% confidence interval is 2025-2095).

land-based glacier.[29] The realization of such a "Green Swan" is likely to devastate the economy; values throughout a diversified portfolio will suffer—including the firm that today faces a choice with implications for the future and its future. A board might decide to cut emissions generating activity today as part of an effort to forestall a sharp economic decline that will devastate the own-firm as well.

The barriers to concerted action by portfolio investors are practical ones—not doctrinal or "theory of the corporation." K&R spend considerable time arguing the futility of Professor Condon's example—ExxonMobil's cutting its production—by pointing out that this foregone production could readily be made up by a non-public, even non-US, producer like Aramco. But of course, this is also why a portfolio investor might not be eager to support directors with this agenda—unless the portfolio investor had a different theory of the case, one grounded in a political path required to evoke governmental restraint.

To me, the key issue is whether "systematic stewardship" is a sustainable strategy considering the core legitimation mechanism of shareholder voting. If directors of a public company pursue a business strategy that will promote positive social externalities or consciously advance an agenda that serves systematic risk reduction, the key issue is not doctrinal or "theory of the corporation." The issue, rather, is whether the shareholders will go for it. If directors act in a way that K&R object to, either the shareholders will throw them out or will not. As I've tried to show, the doctrine and our "theory" are capacious enough to permit that form of legitimation rather than leave it to the courts. Indeed, my opposition to anti-activist pills, relevant in this context as well as others, is that it disrupts this critical avenue of legitimation.[30]

In "Systematic Stewardship," I have laid out a finance-based theory that would justify actions by asset managers in support of measures that would reduce systematic risk, consistent with their duties to the beneficiaries of the assets they manage.[31] But that doesn't mean that these beneficiaries will see it that way and they can act accordingly. Asset managers are in many cases simply agents for institutional investors who are independently capable of deriving an objective function. In a project underway that compares United States and European actions on "sustainability," I have become acutely aware of the way that immediate exposure to stock market returns will condition the preferences of the holders of the greatest amount of shareholder wealth.[32] And the extent to which the United States is a petrostate has implications for stock market returns as well as politics.[33] Those are the pivotal questions in this systematic turn in asset manager behavior, not corporate law constraints.

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29. *See* PATRICK BOLTON ET AL., BANK FOR INT'L SETTLEMENTS, THE GREEN SWAN: CENTRAL BANKING AND FINANCIAL STABILITY IN THE AGE OF CLIMATE CHANGE 3 (2020), https://www.bis.org/publ/othp31.pdf [https://perma.cc/LW4D-KVLP] (distinguishing black and green swans).

30. *See* Jeffrey N. Gordon, *The Rejected Threat of Corporate Vote Suppression: The Rise and Fall of the Anti-Activist Pill*, 2022 COLUM. BUS. L. REV. 206, 207 (2022) (arguing that anti-activist pills disrupt legitimating feature of shareholder voting).

31. *See* Gordon, supra note 1.

32. *See* Jeffrey N. Gordon, *Unbundling Climate Change Risk from ESG*, COLUMBIA L. SCH. BLUE SKY BLOG (July 26, 2023), https://clsbluesky.law.columbia.edu/2023/07/26/unbundling-climate-change-risk-from-esg [https://perma.cc/EFM8-NCN8].

33. *Id.*