The Coming Shift in Shareholder Activism: From "Firm-Specific" to "Systematic Risk" Proxy Campaigns (and How to Enable Them)

By John C. Coffee*
SSRN: https://ssrn.com/abstract=3908163 or http://dx.doi.org/10.2139/ssrn.3908163

Abstract

This article distinguishes two types of shareholder activism: (1) firm-specific activism, which has a long history and focuses on changes at a specific target company, and (2) systematic risk activism, which seeks to reduce the systematic risk in a portfolio and thereby benefit diversified investors. Typically, such a systematic risk campaign may force a portfolio company to internalize negative externalities to benefit the other companies in the portfolio (such as by reducing carbon emissions or undertaking climate risk reforms). But, systematic risk activism faces an inherent difficulty: the party that leads this campaign and invests in the target company may incur a significant loss when the target company's stock price falls. This will be particularly difficult for activist hedge funds to accept, because they have small portfolios and cannot recoup their losses on the target firm by gains at the other portfolio companies. Properly understood, the recent campaign by Engine No. 1 with respect to ExxonMobil exemplifies these problems and suggests that activist hedge funds make ill-suited leaders for this form of activism. If so, there may be a strong demand for systematic risk activism among diversified investors, but potential campaigns could remain headless, as diversified investors will themselves be reluctant to lead such a campaign. This article surveys possible answers to this problem (some of which are suggested by the Engine No. 1 campaign). Nonetheless, this problem surrounding the incentives of hedge funds is aggravated by the traditionally independent stance of diversified investors, who are reluctant to join groups or expend funds, and by the inability of potential campaign leaders to charge adequately for their services. This article suggests several means of which to enable such campaigns.

* Professor Coffee is the Adolf A. Berle Professor of Law at Columbia University Law School and Director of its Center on Corporate Governance.

Introduction

Shareholder activism is about to change dramatically. For decades, shareholder activism has relied upon activist hedge funds that essentially proposed firm-specific interventions at individual public corporations, generally ones that had lagged the market. Typically, the activist's proposal might be to sell off marginal divisions that were only remotely related to the corporation's core business, or to increase leverage or undertake a stock buyback, or to change management at the target. The goal in all these cases is firm-specific: to streamline or "de-conglomeratize" the firm, increase its leverage, or possibly change its management, all in the hopes of increasing its stock price.

No doubt, these individual campaigns will continue, but they may be overtaken in scale and significance by a distinctive new form of activism that is focused less on the individual target firm's stock price and more on enhancing the value of this investor's total portfolio. This latter form of activism is less interested in whether the target firm's stock price rises (or falls) than in whether the activist investor's engagement with the target causes the total value of this investor's portfolio to rise (which means that the gains to the other stocks in the portfolio exceed any loss to the target stock). This recognition that change at one firm can affect the value of other firms in the portfolio implies a new goal for activism: namely, to engineer a net gain for the portfolio, possibly by reducing "negative externalities" that one firm is imposing on other firms in the investor's portfolio. Let's call this latter form of activism "systematic activism" (as opposed to traditional "firm-specific activism" that is focused on only the individual stock).

This new form of activism is the product of possibly the most significant recent development in the structure of shareownership in the United States: namely, an extraordinary concentration in ownership with the result that just a few institutional investors may be able to exercise control. To illustrate, today the three largest institutional asset managers (BlackRock, State Street, and Vanguard – "the Big Three") own over 20% of the shares of all stocks listed on the S&P 500, and as few as ten such institutional investors can often account for a majority of the shares.

Concededly, not all investors are in a position to pursue this latter form of activism because the investor must hold a large portfolio that basically matches the market (as indexed investors usually do by definition) in order to achieve a net gain from this portfolio-wide strategy. To illustrate, suppose this new type of activist investor proposes that a large oil company (e.g., ExxonMobil, Chevron, etc.) undertake a policy of achieving carbon neutrality by a given date (say, 2035). This investor undertakes a proxy campaign that will seek to elect directors to this target company's board that will pursue this policy, understanding that, if successful, this proxy campaign may reduce the stock price of the oil company. The diversified investor can accept this likely stock price decline at the target if the policy promises to raise the overall value of its portfolio by curbing a negative externality (for example, pollution and adverse climate change). If the other firms in its portfolio gain from reduced pollution, this broadly diversified investor

profits -- at least to the extent that the gains to the other firms in its portfolio exceed the losses to the target firm.

Systematic activism requires, however, a special class of investor with two distinctive, but related, characteristics: First, it must hold a large portfolio that is sufficiently diversified that it includes both the likely winners and the likely losers from such a policy (with the gains exceeding the losses). Second, this investor must be focused on "systematic risk" and relatively uninterested in firm-specific market movements. The typical hedge fund lacks these characteristics, as its much smaller portfolio does not match the market or include sufficient stocks to benefit from the termination of the negative externality. The obvious implication then is that activist hedge funds may be unwilling or ill-suited to lead systematic risk campaigns.[1]

Who then could replace them? These two conditions – a market-spanning portfolio and a focus on systematic risk – do characterize that the major index funds that are coming to dominate the stock market. Not only do the Big Three today own over 20% of the stock in the S&P 500 (and vote about 25% of the shares in those firms), but the holdings of indexed funds have recently surpassed those of actively managed funds. Today, an indexed investor may hold on a long-term basis more than 10,000 individual stocks (as State Street does), and thus it cannot monitor in any meaningful way the individual stocks in its portfolio. Because high diversification protects these investors against declines in individual stocks (as one firm's decline is likely to be matched by another firm's gain), they are instead rationally preoccupied with "systematic risk," which technically means a risk that cannot be eliminated through diversification. Economic theory has long taught that fully diversified investors should ignore the characteristics and performance of individual stocks and instead focus on minimizing systematic risk.

The clearest example today of a major systematic risk is the risk of adverse climate change. Diversified investors see this as the one risk that could decimate their portfolios, and thus it should not surprise us that the leading index funds and asset managers have been the most outspoken proponents of reducing our dependence on carbon-based energy. BlackRock, the world's largest asset manager, has been the most vocal on this score,[2] but the other two members of the Big Three have not lagged far behind it.

---

[1] Part of the premise here is that the gains to other portfolio companies (if investors force the externality-creating company in their portfolios to internalize its externalities) will be relatively small per issuer. For example, forcing an oil company to reduce its carbon emissions may cost the oil company a 25% decline in stock price, but the gains at the other portfolio companies that benefit may be well less than 1% each. Thus, only investors with a large portfolio can profit from this policy…

[2] In January, 2021, BlackRock's CEO, Larry Fink, wrote to the CEOs of major public corporations, asking them to commit to a "goal of net zero greenhouse gas emissions by 2050." See Larry Fink, "Letter to CEOs," Harvard Law School Forum on Corporate Governance, January 30, 2021. It is only a small step from asking for such action to voting for it in a proxy contest, and BlackRock appears to have taken that additional step. One survey finds that, for the first six months of 2021, BlackRock voted on 170 ESG

All in all, this new activism on the part of these investors represents a major reversal, but an entirely logical one. Until recently, the major index funds were notoriously passive investors, seldom involving themselves in specific issues at their portfolio companies. This passivity was rational and the product of two linked factors: (1) A diversified large portfolio not only made firm- specific interventions infeasible, but often pointless (as any change that reduced the value of some stocks typically raised the value of others, thus making passivity the better and lower-cost policy), and (2) indexed investors generally invested in the same indexes. Thus, for example, if a BlackRock expended funds to correct a problem at a portfolio company in the S&P 500 index, it would benefit its rivals as much as itself (and only it would have expended funds, while its rivals free-rode on its efforts). As later discussed, this desire not to benefit one's rivals at one's own expense is not a total barrier to activism, but it requires agreement on an equitable means of cost sharing.

These barriers to activism in the case of the fully diversified investor are offset, however, by two other developments: First, indexed investors are increasingly concerned about systematic risk because they see climate change as a risk that they cannot quantify or diversify away; they fear that they are effectively defenseless and that many of the managements of their portfolio companies are stubbornly blind to this risk. Second, because they enjoy extraordinary levels of cross-ownership, these shareholders can take action at low cost to themselves to impose restraints on the managements of their portfolio companies. If some companies are imposing negative externalities on the market as a whole, it would be both rational and feasible for large index investors to seek to curb such conduct (at least when the gains from such efforts are expected to exceed the losses to the companies imposing such externalities).

This introduction frames the narrow topic on which this brief article will focus: how can broadly diversified investors be encouraged to become activists? Because of the high common ownership that they share, collective action becomes feasible, but these investors remain reticent to spend funds or take actions that benefit their rivals at their expense. This reticence is aggravated by the fact that index funds compete less on the basis of market performance and more on their ability to minimize costs. How can they be encouraged to overcome their normal reticence and become involved in corporate governance? Here, an initial answer should now be obvious: indexed investors are only likely to become involved in issues that involve systematic risk. Although there may be some minor exceptions to this generalization, the fundamental truth is that only systematic risk truly threatens diversified investors. Today, the risk of climate change is the most urgent risk that they face, and their behavior in recent proxy battles shows that they recognize this.

---

shareholder proposals, backing 91% of the environmental proposals, 22% of the social proposals, and 26% of the corporate governance proposals….

But, even if systematic risks can induce indexed investors to take action, these investors would prefer to follow than to lead (because they thereby incur far lower costs). Such a preference is not only less costly, but minimizes their exposure to political or legal retaliation and reduces the risk of some forms of securities law liabilities. In addition, because they have promised shareholders that they will not exit from the indexes that they have invested, indexed investors have limited options and must rely on voice, not exit, to promote change at portfolio companies. Accordingly, this article argues that the best policy for them is to achieve equitable cost-sharing among themselves so that none of these diversified investors is forced to subsidize its rivals. Only under such a system are they likely to fund activism and go beyond simply voting their shares.

Lastly, there remains the issue of what the indexed investors can actually do. Delaware law is clear that shareholders cannot impose bylaw amendments that the incumbent board believes would cause them to breach their fiduciary duties. Nor do institutional investors want to actually control or manage the business. They know that they have neither the experience nor logistical capacity to monitor closely, given the enormous size of their portfolios. Also, by avoiding direct control, they can minimize the risks of securities law liability as a "controlling person" or of becoming subject to legal or political reprisals if they are perceived as "throwing their weight around." Finally, the major diversified investors are asset managers that want to attract new clients and thus prefer to maintain a low profile and avoid controversy. If they led the campaign, they would be certain to attract greater controversy.

So what can these investors do? This article will make some specific proposals, but the basic approach is to find ways by which they can follow, rather than lead, systematic activism campaigns. But, while following, the giant indexed investors can subsidize those who lead (or force the target corporation to bear those costs). When the target corporation is compelled to bear the reasonable proxy expenses of insurgents, the costs of activism are automatically equitably shared.

Some may respond that there is no problem here and diversified investors do not need to do more, because activist hedge funds will happily assume a leadership role (and have done so many times). But this answer ignores the fundamental difference between firm-specific activism (where activist hedge funds do play that role) and systematic activism (where they are much less likely to be able to play this role). This is the key point that most recent commentators have ignored. For systematic activism to work, someone else must play the role of the catalyst who starts the campaign.

To give a brief roadmap of this article, Part I will explain in more detail why the activist hedge fund cannot normally lead a systematic risk campaign. Part II will examine the recent campaign at ExxonMobil in which a very small hedge fund (Engine No. 1) did in fact lead a campaign that

elected directors at the world's largest oil company (ExxonMobil). It will then explain why this example is consistent with this article's analysis and shows a motivation that can be potentially utilized. Part III will turn to what the relationship should be between indexed investors and their agent who initiates the contest. Part IV will turn to what activists can do to realize their agenda without actively seizing control and electing a majority of the board. Finally, in conclusion, Part V will integrate these steps and suggest a likely timetable for action.

Part I: Why the Hedge Fund Will Rarely Lead A Systematic Risk Campaign

The normal approach of an activist hedge fund to an "engagement" with an underperforming company follows several standard steps: First, it identifies a shortcoming that is correctable (for example, a division unrelated to its main line of business that it can sell at a profit and invest the proceeds in a stock buyback). Second, it acquires a significant stake, usually just over 5% (thereby triggering an obligation under the Williams Act to file a Schedule 13D) with the SEC, in which it discloses its proposed plans for the target company. At or before this point, it may assemble a small circle of allies who will invest with it in the target before the public disclosure is made. Third, upon the filing of the Schedule 13D, there is usually a significant jump in the target stock price (typically, an abnormal return of around 6%). With this indication of market support for its plans, it approaches the target's management to seek the changes outlined in its Schedule 13D and to obtain representation on the target's board. The implicit threat is that if the target does not cooperate, it will launch a hostile proxy fight, possibly even one seeking control of the target. Target management is usually risk-averse (having seen other such campaigns win). Generally, a compromise is struck under which the insurgents gain some seats and the proxy contest is called off. If an actually proxy contest is launched, diversified investors may or may not support the insurgents on this firm-specific issue, but they will only have to vote and not expend funds on the contest.

Will the same tactics work in the case of a systemic risk campaign where diversified investors are seeking to reduce their exposure to systemic risk? Suppose, for example, an insurgent activist proposes that the target company become "carbon neutral" by a specific date, and target management replies that the costs of such a proposed reform would be "prohibitive." This reply may be an exaggeration, but the target's stock price sinks in response. Diversified investors may be able to accept this prospect with equanimity (because they expect to make gains on other stocks in their portfolio that will outweigh the losses on the target stock). But an undiversified hedge fund is not in their position and faces only losses. Its portfolio is generally way too small for gains on the other stocks to overcome the losses on the target stock. Logically, this should preclude its participation in a campaign where the target stock is likely to fall.

This does not imply that an activist fund will never lead a systemic risk campaign. For example, sometimes an engagement may promise both firm-specific gains and a reduction in systematic risk. Other times, as later discussed, the engagement may provide reputational benefits and thus

increased assets under management to the activist fund (with a resulting increase in the fees it receives annually from its clients). Still, these are likely to be the minority of cases. Hence, either some other candidate must be found to lead such a campaign, or the activist fund must be compensated in a way that incentivizes it and protects it from losses. Several possibilities will later be considered, including a "public interest" proxy contestant, but first it is necessary to take a closer look at the most important recent proxy contest involving climate change issues.

Part II: The Implications of the Engine No.1 Proxy Campaign at ExxonMobil

In 2021, a tiny and very new hedge fund – Engine No.1 LLC – lead a surprising campaign that elected three directors to the board of ExxonMobil Corp. Founded only in 2020, Engine No.1 was a brash upstart with only $250 million in assets under management. In fact, even this money came almost entirely from its founder, Chris James, a hedge fund veteran, and not from outside investors. Few believed that it could realistically take on a giant and intransigent oil company the size of ExxonMobil. After all, in contrast to ExxonMobil's market capitalization of $250 billion, Engine No.1's stake in ExxonMobil came at most to $50 million (or 0.02 percent of ExxonMobil's stock) at the time of the shareholder vote. Perhaps for this reason, ExxonMobil showed little willingness to compromise with Engine No.1 (although ExxonMobil had settled with larger activist funds by adding three new directors to its board). In addition, Engine No.1 was more demanding than its larger activist rivals, asking for four seats on the ExxonMobil board plus diversification away from oil and carbon. Thus, even though ExxonMobil had underperformed its oil rivals over recent years, it had the support of its retail shareholders, did not perceive that it was vulnerable, and thus made little effort to settle.

Yet, although Engine No. 1 was a minnow attacking a whale, it had large allies, and ExxonMobil was vulnerable, having incurred a $22 billion loss in 2020. It began its campaign with the support of California State Teachers' Retirement System and California Public Employees' Retirement System (two of the largest public pension funds in the country), and it soon picked up the support of the Big Three (BlackRock, State Street, and Vanguard) for most of its candidates. To demonstrate its seriousness, Engine No.1 also spent money freely, running a six-month campaign to which it claims to have allocated nearly $30 million for proxy expenses.

That Engine No. 1 won this fight shows beyond question that a small firm can serve as the catalyst for a successful campaign against even the largest target – if it can win the support of the major diversified investors. Even though ExxonMobil had an unusually high level of retail shareholder ownership (47%) and such shareholders usually back management in proxy contests, Engine No. 1 still won. This suggests that clearly large corporations with lower levels of retail shareholders are even more vulnerable than ExxonMobil. The need for the support of diversified investors is even more critical because it implies that the organizer of the proxy campaign need not make a substantial investment in the target. This expands significantly the number of eligible candidates who could run a systematic risk campaign.

Still, a latent issue lurks here and need to be faced: did Engine No.1 succeed in a manner that will encourage and enable others to follow its example? Unlikely as its victory had seemed, the stock price of ExxonMobil did not move in response to the results of the proxy contest. On May 25, 2021 (the day before the shareholder vote at ExxonMobil), ExxonMobil stock closed at $58.26; on May 26, its stock closed at $58.94 (but the outcome may not have been fully revealed at the time the market closed). On May 27, ExxonMobil's stock price fell to $58.56, and at week's end on May 28, ExxonMobil's price was down to $58.37 at the close – a net change of only 11 cents over the period from Wednesday to Friday.

In short, the market seemed indifferent to Engine No.1's success, which could have cost it as much as $30 million in proxy expenses. Nor can this market reaction be explained in terms of the market expecting a victory by Engine No.1 (because it did not). Instead, it suggests that even surprisingly successful systematic risk campaigns will not produce immediate stock price gains at the target. Possibly, the market may have believed that these newly elected directors could do little to change ExxonMobil's strategy or its stubborn loyalty to carbon-based fuels.

What then are the implications of Engine No.1's victory for future contests? If a proxy contestant may have to spend as much as $30 million on a single proxy contest that produces no immediate stock price improvement, this looks like a costly Pyrrhic victory for such a contestant. This is particularly true in Engine No.1's case, where it only had $250 million in assets under management (and thus spent a material portion of its assets on just one proxy contest). To be sure, ExxonMobil's stock price did later rise significantly (along with those of the other oil companies) when the pandemic eased and the demand for oil increased rapidly in anticipation of increased airline and auto travel. But this may have been the product more of luck than a clever strategy by Engine No.1. The irony is that ExxonMobil's stock rose (and benefitted Engine No. 1) precisely because oil as a commodity became more valuable than Engine No. 1 and its supporters had expected.

If Engine No.1 had expected oil stocks to rebound, it would have had little need to initiate an expensive proxy contest to realize the firm-specific gains incident to a cyclical rebound in oil prices. Instead, the likelihood is that Engine No.1 viewed its plan to push ExxonMobil to diversify away from carbon-based fuels as a sound firm-specific strategy that should have attracted support from both diversified and undiversified investors, both of whom had long pushed ExxonMobil to diversify. Yet, the lack of a price reaction to its success suggests that the market was underwhelmed (or at least saw ExxonMobil as still too intransigent to change).

Still, over the longer term, Engine No.1 may have had an adroit strategy in mind. By winning a notable victory, it placed itself prominently on the map of shareholder activism and now is in a position to seek to convince institutional investors to invest with it. For example, if it were able to increase its assets under management from $250 million to $2.5 billion (i.e., ten times), this would imply increased fees to it under the standard formula used by most hedge funds to govern

their compensation (i.e., 2% of assets under management annually plus 20% of profits, if any). Here, even without profits, such an increase in assets under management would imply an annual increase in fees of $45 million (which could justify the alleged $30 million costs of the proxy battle). Although this scenario is plausible, if unproven, one piece of evidence corroborates this scenario that Engine No. 1 could profit even without a stock price gain at ExxonMobil: following its victory, Engine No.1 successfully launched a new exchange-traded fund ("ETF") that it marketed to diversified investors. Other hedge funds may emulate this strategy if they can pull off their own notable success. Some commentators have observed that Engine No. 1 is now surrounded by "a halo of environmental virtue" and "it can fundraise off that forever." Perhaps, this is true (and certainly a celebrity status can be exploited on Wall Street), but it is more likely that the new investors in these funds will need at some point to see stock gains that were attributable to the efforts of the fund's organizers if they are to maintain their investment in its fund.

One final fact about Engine No. 1's campaign may have recurring relevance. In an SEC filing at the time of its proxy campaign, Engine No. 1 reported that it held only 13 stocks (with the largest holding being ExxonMobil, which represented 19% of its securities holdings). This contrasts sharply with a diversified investor, such as State Street, which holds some 10,000 stocks. Most of the other stocks held by Engine No. 1 were also high-tech firms. Nothing suggests that the other firms in Engine No. 1's portfolio would benefit to such an extent that the gains at these firms would offset or overcome the expected loss to the target firm (here, ExxonMobil), whose externality-causing behavior Engine No. 1 was seeking to curb. Again, this suggests that small activist firms do not hold sufficiently large or diversified portfolios to enable them to conduct and profit from a systemic risk campaign.

The bottom line then remains problematic. In principle, a start-up fund may be able to justify large expenditures to gain attention and attract investors, but its long-term ability to serve as the catalyst for future systematic risk campaigns depends upon its ability to increase portfolio value for its investors. Victory in such a contest is never assured, and the costs of recurring proxy campaigns may overwhelm corresponding gains for all but the largest of diversified investors.

Part III: Who Could or Should Lead Diversified Investors in a Systematic Risk Campaign?

As already noted, diversified funds invest in the same indexes, and because they thus cannot compete in terms of investment strategy, they compete instead to minimize costs. Given this cost-minimization orientation, they appear reluctant to spend funds on a proxy campaign that will affect only one stock (when they hold 10,000 different stocks). Thus, diversified funds want someone else to initiate the proxy contest, solicit the shareholders, and hopefully handle the settlement negotiations. As also earlier noted, the activist hedge fund cannot fill this void easily because the risk of a decline in the target's stock price deters it. If so, who else can play this role?

Several answers are plausible, and three options will be considered below:

1. The Entrepreneurial Proxy Contestant. The simplest way to minimize the costs of a proxy contest is to reduce the size of the stake that the activist running the campaign holds in the target firm. Traditionally, hedge funds made a large investment in the target both because it was in effect buying votes and because it expected to profit from the increase in the target's stock price. But Engine No. 1's success shows that future contests can be organized by a firm that made a minimal investment in the target -- so long as it could present itself as a credible challenger. A firm with expertise in proxy solicitations could logically run the contest itself, either directly or through a wholly-owned subsidiary. Today, Institutional Shareholder Services (ISS) and Glass Lewis dominate the market for proxy advice. Given their visibility and expertise, they would be the most logical candidates to branch out and operate a subsidiary that ran proxy contests that its clients would support. Yes, this would generate conflicts of interest, but these could be elaborately disclosed. The claim here is not that they want to extend their reach to running proxy contests, but that they are well positioned so that they could.

An attraction for these entities is that they could hold stakes in potential target firms in amounts even smaller than that held by Engine No.1. No minimum level of stock ownership is required to launch a proxy contest. As a practical matter, some minimum stake is probably necessary to make the proxy contestant appear credible. However, credibility for the campaign can come from others who have aligned with it publicly. For example, if a small fund held only an investment of $5 million, it still should appear credible if it had also gained the public support of the Big Three, major pension funds, or other well-known diversified investors.

The real and greater barrier is the size of the proxy expenses needed to support a proxy solicitation at a major corporation. The $30 million allocated by Engine No.1 to proxy expenses is likely higher than necessary, but an amount well in excess of $1 million will usually be needed. Engine No. 1 greatly economized on its costs by focusing only on institutional investors and ignoring retail investors. Others may follow its example. More importantly, proxy expenses can be shared by agreement among interested institutional investors. Here, there are both legal and economic difficulties that complicate such sharing. Investors subject to ERISA (including most pension funds) may have difficulty justifying such payments, unless they can show that they reasonably expected a positive economic return from a successful campaign. In any event, index funds are likely to resist any large contribution, given their traditional focus on minimizing costs.

The best practical answer to this problem is to force the target company to reimburse the lead proxy contestant's reasonable expenses. This is easier said than done, but it is generally allowable under state law (at least where a serious policy issue underlies the proxy contest, as it would here). Although the target corporation will resist reimbursement, its management is caught between the rock and the hard place. If the proxy campaign appears viable (and the Engine No.1

contest greatly expands our sense of what is viable), the target company's management risks shareholder repudiation and humiliation if it loses the proxy fight. Indeed, the target's management may find itself ousted from office in the wake of such a defeat. Recent experience with firm- specific proxy contests has shown target managements to behave in a risk-averse manner and agree to settle in a very high percentage of all cases by giving the insurgents one or more seats on its board. Possibly, the insurgents might have to scale down their demands for board seats to reach such a settlement where they did not have the funds to support a costly proxy campaign, but the Engine No.1 experience will only increase target management's level of risk aversion.

In short, this approach uses a private entrepreneur to play the role of the proxy contestant that is normally played by an activist hedge fund. If this entrepreneur were not a mutual fund, hedge fund, or an investment adviser, it could escape much regulation. But the viability of this proposal depends on whether sufficient capital can be raised to make the proxy contest appear credible. That problem will be returned to shortly.

2. Shareholder Agreements. Large shareholders can, of course, agree to fund the expenses of a proxy contest by means of a shareholder agreement. Delaware law will enforce such agreements, but care must be taken to ensure that the solicitation of parties to join such a shareholders' agreement does not itself amount to a proxy solicitation under federal law or make those contributing to a proxy campaign fund members of a "group" for purposes of the Williams Act.

In any event, the law is less of a problem than the economics: index funds remain parsimonious and natural "loners," and it would be a departure from their prior practice to contribute to a common campaign fund. Here, it is time to offer a hypothesis: It may be that the greater problem is not that index funds are inherently cheap, but that they do not want to subsidize their rivals. Thus, if an equitable cost-sharing formula could be negotiated, it is more plausible that the major index funds would be willing to contribute their proportionate share (based, for example, on some formula such as market capitalization or industry share). These funds would still hope that these expenses would be ultimately reimbursed by the target corporation (if the contest were successful or if a settlement were reached), but success cannot be assumed.

Different approaches could be used to direct such a contribution so that it covered the reasonably foreseeable proxy expenses of the party leading the proxy solicitation. If this party had or created a subsidiary that was a hedge fund or mutual fund (including an ETF, which was Engine No. 1's vehicle of choice), supporting diversified investors could buy shares in it. Alternatively, a cash payment could be made by large diversified investors to a trust fund with independent trustees who would determine which proxy campaigns, if any, it would back. This keeps the contributing index funds out of the direct financing of the proxy contest, so they can maintain that all they are doing is voting their shares…But the goal is that the Big Three and others would be able to advance the estimated costs of at least a limited number of systematic risk proxy battles annually,

and their contributions to such a special fund (and not to a specific proxy campaign) could be characterized as made to protect the environment and slow climate change through better corporate governance – arguably, a charitable purpose.

3. A "Public Interest" Proxy Advocate? A final possibility is to create a "public interest" body, with an independent, blue ribbon board, to bring proxy contest on issues within their special competence. For example, public interest environmental organizations – such as the Environmental Defense Fund (EDF) or the Natural Resources Defense Council (NRDC) – could establish subsidiaries, or more loosely connected affiliates, and would help propose, draft, and lobby for proxy resolutions to be voted on by the shareholders of various energy-related companies. For example, these resolutions might propose dates by which the company would become "carbon neutral" (as that term is defined by the resolution). These entities might not qualify as tax exempt bodies, but they do not need to seek donations. Their proxy expenses would be largely covered by the special fund discussed earlier that would be created by the leading index funds; again, the independent board of that fund would determine which contests it would back.

The goal here is to create a public interest body that contributes its prestige, expertise, and reputation for integrity. In general, these public interest bodies have a surplus of reputational capital which they are in effect lending to proxy contestants that may lack such a surplus. Put simply, a proxy proposal drafted or vetted by a trusted environmental organization simply has greater credibility. It is not strictly necessary that any of the major environmental public interest organizations formally back such an arrangement, so long as some of their alumni or directors will accept some role that shows the affiliation.

Part IV: What Should A Systematic Risk Campaign Attempt to Do?

There is much that a shareholder-led proxy campaign cannot do. For example, under Delaware law, the board is not bound by shareholder-adopted by-law amendments, at least when the board believes that the by-law would force it to take actions inconsistent with its fiduciary duties (as interpreted by the board). More generally, the corporate law of all U.S. jurisdictions delegates the management and control of the corporation to its board of directors, not the shareholders. In short, shareholders cannot micromanage. So what can they do? Let's take this in a series of procedural steps and then turn to a larger issue that overshadows this context: what are the fiduciary duties of directors who act to pursue a policy goal (such as climate change reforms) that will predictably reduce the corporation's stock price?

A. The Procedural Steps in a Systematic Risk Campaign.
Step One: as a practical matter, a shareholder coalition is probably best advised not to seek outright control of the board as an initial step. Shareholders, particularly including institutional shareholders, do not want to cede control unless they are paid a control premium. Our

hypothetical systematic risk coalition does not want to pay such a premium or to be deemed to hold control. Thus, they should seek only a minority of the seats – say, three or four – initially, holding in reserve the implicit threat that if their proposals were ignored, then they will seek control.

Step Two: the next question is where its partial slate of candidates should serve on the board. This article will propose that one of the most important levers to be used is the board's control over executive compensation. Increasingly, activists are demanding that executive compensation formulas factor in whether the target company's executives are meeting its ESG goals. The first step towards this end is to design ESG metrics that would be used to determine executive compensation, and some models are already in use. The basic idea is thus to motivate (or seduce) executives into greater attention to climate change and ESG criteria. Far cheaper than to sue executives or to seek to oust them through proxy fights is simply to pay them to do what shareholders want.

Step Three: the other key leverage point is the audit committee, were ESG metrics need to be introduced into the corporation's thinking. Although the SEC appears likely to eventually compel public corporations to meld ESG metrics into GAAP accounting principles, activists do not have to wait for SEC action. Audit committees can conduct their own surveys and decide if their company is lagging behind its industry or peers in meeting ESG standards. Thus, a seat on the audit committee is an obvious target for a systematic risk proxy campaign.

Step Four: assume that the directors elected by the activists who bring the proxy campaign meet stubborn resistance. What do they do next? Do they seek to elect a majority of the board at the next annual meeting? The problem here is we are once again giving control to a group that is not paying any control premium. A potentially superior approach is to argue to the board's majority that, unless they can agree on a new CEO, the activists will be forced to seek to oust the other directors as well. This will all be behind the scenes, and thus will not make the corporation look dysfunctional. Accordingly, this tactic preserves at least some appearance of consensus and continuity. To be sure, this last step is one that institutional investors will be reluctant to take and may provoke extended discussion and uncertainty.

B. What are the Fiduciary Obligations of a Director Who Takes Action that Foreseeably Reduces the Corporation's Stock Price?

Directors generally see their duty as to maximize share value. This is less a statement of Delaware law (or the law of any other jurisdiction) than a description of prevailing business culture. Maximizing share value is the touchstone for directorial decision-making. But the unique consequence of adopting a portfolio-wide investment strategy (which diversified investors logically should favor) is that it can rationally lead to a decision that foreseeably reduces the value of the stock of the company that the director serves. This makes rational sense so long as

there is a net gain to the investor's portfolio. Yet the individual director does not serve, or owe duties to, these other companies but only to the one company that will suffer the stock price decline. Can this director sacrifice the interest of these shareholders to the greater good of the other shareholders to whom he owes no duty? No precedent is precisely on point, but at least where this director foresees a loss to his beneficiary, he may be in a difficult position.

But just how difficult? There are many occasions on which a director may willingly accept a decline in the company share value if the director anticipates a greater long-term gain in that stock. For example, the rejection of a hostile tender offer will almost always produce a stock market decline, but this can be justified on the belief that the company was undervalued by that tender offer. Similarly, the business judgement rule will safely protect a director who votes to continue funding an expensive research and development project that has been unsuccessful for a decade or more. Even in a systematic risk campaign, it will often be the case that the director's vote for, say, a substantial reduction in carbon emissions can be justified as leading to a longer term gain. But this is not always true. If the directors of an energy company vote to reduce producing carbon-based fuels but have no available alternative in the solar or wind-powered fields, the company may well suffer a significant decline in share value without the prospect of a longer- term turnaround.

Directors, of course, do not need to rely on business judgement rule for protection if their claimed breach is of the duty of care. Whether incorporated in Delaware or elsewhere, most boards are today protected by a charter provision adopted pursuant to Section 102(b)(7) of the Delaware General Corporation Law (or a similar provision that most other states have) that largely eliminates monetary liability for a breach of the duty of care (at least if the requisite charter provision is adopted). This provision is, however, subject to some exceptions, of which most relevant is an exclusion "for acts or omissions not in good faith." In a leading Delaware decision, the Delaware Supreme Court ruled that:

"Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."

It is not hard to imagine plaintiffs alleging in their complaint that directors who imposed climate control restrictions on their corporation that foreseeably resulted in a sharp stock price drop "demonstrated a conscious disregard" for their duties. Much will depend on the facts and how the board justified its decision.

The duty of loyalty is also not covered by Section 102(b)(7). Thus, if a director was in a conflicted position, serving as both an officer or employee of a large diversified investor (which benefits from this climate change restriction) and also a director of this company that suffers the

stock price drop, plaintiffs will assert that this director had divided loyalties and knowingly subordinated his duty to the shareholders to the interests of the director's employer.

The practical answer to this latter problem is for the director elected in a systematic risk campaign to avoid any such conflicted position. That is, the director should not be an officer or employee of the diversified investor, but can be a retired executive or director of an energy company (presumably with long experience in the industry). This was exactly the position of the directors nominated by Engine No. 1 in the ExxonMobil proxy campaign. Careful lawyers will also urge the board to explain why they believe they are benefitting their company over the long run. Even if these statements appear cosmetic, courts will likely not be eager to impose monetary liability on directors who are trying to "save the earth" by introducing climate change reform. Particularly if coupled with substantial D&O insurance, the position of these directors does not appear to be unacceptably risky (if they have avoided a conflicted position).

Part V: Conclusion

Systematic risk campaigns and firm-specific campaigns will likely coexist on a side-by-side basis, with many proxy campaigns exhibiting some characteristics of both. The immediate question for the present is who can lead a systematic risk campaign. On the one hand, a campaign leader does not need to acquire a substantial stake in the target (as Engine No. 1 has shown). On the other hand, such a campaign organizer faces two substantial problems:

First, it must fund the substantial costs of a proxy campaign, which is particularly costly when the target's stock price is likely to decline. Some may argue that this organizer only has to follow Engine No.1's example and seek a profit by attracting new investments to its fund or to an ETF that it establishes. Still, Engine No. 1 may not prove to be the prototype for the future, as later successes are unlikely to generate the same favorable publicity or create the same reputational capital. "Lucky" Lindbergh became world famous for being the first to fly the Atlantic solo, but no one remembers who was the second or third.

Second, the extraordinary disparity between the 10,000 or more stocks held by an indexed investor (such as State Street) and the 13 stocks held by Engine No. 1 shows that the typical hedge fund cannot profit, itself, from strategic risk activism (because its portfolio is simply too small). Nor is it feasible to lead a proxy campaign while holding a large short position in the target. Thus the organizer will typically need to profit as an agent of diversified investors, rather than as a principal in its own right. The potential organizer needs to form an implicit partnership with diversified investors, and therein lie the problems.

As of today, we know that diversified institutional investors will consistently vote for climate change resolutions and often for candidates sympathetic to such goals. But will they pick up any of the cost? Before institutions will enter into any such relationship with a campaign organizer,

serving as their agent, they will likely want (i) a campaign leader that is prudent, non-confrontational, focused on the facts, and devoid of ideology, and (ii) assurance that their role in providing financial support will not make them a member of a "group" for purposes of the Williams Act. Such criteria may rule out some activist hedge funds that have shown little skill at diplomacy and a preference for an aggressive posture that generates publicity. More importantly, diversified investors will need to find a means other than a direct cash payment by which to support the campaign. For example, they could agree on a cost sharing arrangement, under which they purchase shares or other interests in their de facto agent. This would protect their agent in the event that the campaign is unsuccessful (and the target corporation will thus not reimburse the agent's proxy expenses), but merely owning one or two percent of a fund does not imply that one is a co-partner in a "group" with that fund.

Given their tradition of independence, large, diversified investors may be slow to agree among themselves on cost-sharing arrangements. In earlier decades, such arrangements did develop in the U.K. among the leading institutional investors, but they appear to have permitted smaller institutions to free-ride on the efforts of their larger colleagues. Cost-sharing arrangements could be structured in a variety of ways, including as small investments in a fund established by the proxy campaign organizer, and need not make the institutional investor a member of a Williams Act "group." If such arrangements can be achieved, an adequate supply of candidates to lead proxy campaigns should naturally follow. Still, this remains a significant and uncertain "if."