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2023

## Who Are Quality Shareholders and Why You Should Care

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### Recommended Citation

47 Del. J. Corp. L. 575

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# WHO ARE QUALITY SHAREHOLDERS AND WHY YOU SHOULD CARE

LAWRENCE A. CUNNINGHAM\*

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The stated purpose of the Pileggi Lecture is to create an opportunity for those “distinguished” in corporate law and governance to address those “most responsible for shaping it:” the Delaware bench and bar. The message I’d like to share is this: you are doing an excellent job, and please keep it up. A few takeaways upfront:

- I concur with the widely held view that Delaware’s corporate law is a national treasure.
- evidence shows that Delaware’s “made-to-measure” approach to corporate governance is supported by America’s most patient and focused investors—called “quality shareholders”.
- there’s reason for great skepticism about the trend toward “one size fits all” governance favored by America’s indexing investor community and to resist efforts by certain shareholders to rule corporate boardrooms.

In this lecture, after summarizing the “Delaware way,” I’ll detail my research on shareholder variety, then canvas core topics in corporate governance today along with corporate purpose. The review will show not only the soundness of the Delaware approach but Delaware’s critical role—your critical role—in maintaining the boundaries to protect it.

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\*Special Counsel, Mayer Brown LLP; Henry St. George Tucker III Research Professor Emeritus, George Washington University; Founding Director, Quality Shareholders Group. For comments thanks to: Steve Bainbridge, Stephanie Cuba, Charles Elson, Jesse Fried, Paul Mahoney, Dale Osterle, Anna Pinedo, Roberta Romano and Christina Parajon Skinner. On February 10, 2023, I was honored to deliver the 37th Annual Francis X. Pileggi Distinguished Lecture in Law to the Delaware bench and bar and to the faculty and students of Delaware Law School. The following is the text of that speech substantially as presented, including a few of the slides presented, and supplemented with footnotes.

## I. THE DELAWARE WAY

For nearly a century, every law student across the United States taking the corporations course has learned the Delaware way.

Delaware corporate law envisions distinct, coordinated roles within a corporation. Shareholders elect the board and the board oversees the corporation, chiefly by appointing, directing and supervising managers, as well as shaping business strategy.

The Delaware General Corporation Law (DGCL) has some mandatory terms, but is mostly an enabling statute offering alternatives. Specific items must be set forth in the charter, which can be amended only jointly by the board and shareholders, and others in the bylaws, which can be amended by the shareholders alone and, if the company wishes, by the board. Almost all governance provisions can be tailored to suit the needs of an individual company.

Delaware decisional law is principles based, equitable and sophisticated, with doctrinal prisms, presumptions, and shifting burdens of proof. Almost all board decisions receive judicial deference, under the business judgment rule. Some decisions, mainly those involving conflicts of interest or changes of control, are given heightened scrutiny to ensure fairness to shareholders.

In short, Delaware corporate law is enabling, deferential, and aims to protect the shareholders. It defines the norm in corporate governance as recognizing differences among companies—the need to tailor governance to fit. Traditionally, shareholders have concurred in this structure.

In recent years, however, some express a divergent philosophy: one size fits all. They prefer a universal and prescriptive governance formula. They also veer into the board room, issuing “expectations” of what directors and companies should be doing in a host of areas, from the workforce and customer markets to community impact.

This cohort prescribes a single set of requirements in both corporate governance and behavior. A common argument for favored policies is: “everyone else is doing it, you should too.” I’ve often heard that argument myself in my professional capacities.

But the cohort I hear it from most is my young children. And as I remind my kids, the argument is specious. It’s never a good idea for anyone to cave to peer pressure and mindlessly follow the crowd. It’s even more dangerous for institutions such as corporations to fall for that fallacy of social proof.

All this has made me wonder, *why?* Why this genuflection to one-size-fits-all? Why this divergence from the Delaware way? I found

answers in the study of shareholder demographics. I'll first present some illuminating research, then turn to specific corporate topics.

## II. SHAREHOLDER TYPOLOGIES

Shareholders are not monolithic. They vary widely based on many characteristics. They have different time horizons and degrees of concentration. They may be deferential or antagonistic to management. Companies have long tried to cultivate their shareholder base accordingly.

A classic analogy appears in the 1958 book by stock picker Phil Fisher.<sup>2</sup> The famed investor likened companies to restaurants. Each offers a menu attracting a given clientele. Five-star cuisine attracts gourmards, fast food catches eaters on the run, and buffets draw an indiscriminate crowd.

From his start in the late 1970s and early 1980s, Berkshire Hathaway's Warren Buffett took Fisher's advice.<sup>3</sup> Through shareholder letters, annual meetings, and company policy, he tried to attract what he called "high quality shareholders," those who see themselves not merely as shareholders, but as business owners.<sup>4</sup> They are focused and long-term.

These insights inspired others, starting with corporate officers and directors, to appreciate the value of having patient and interested owners, not fleeting or distracted ones.<sup>5</sup> Advisors reinforce this message. Consultants at McKinsey, as well as many investor relation firms, stress how long-term focused shareholders are patient through short-term adversity.<sup>6</sup> Proxy solicitors and raid defense firms stress the quality shareholders' willingness to focus on company-specific details.

Among scholars, Harvard's Michael Porter was one of the first researchers to reference the topic. In his classic work exploring international businesses, he explained how a nation's investor types

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<sup>2</sup> PHILIP A. FISHER, *COMMON STOCKS AND UNCOMMON PROFITS* (1958).

<sup>3</sup> WARREN E. BUFFETT & LAWRENCE A. CUNNINGHAM, *THE ESSAYS OF WARREN BUFFETT: LESSONS FOR CORPORATE AMERICA* (8th ed. 2023) [hereinafter BUFFETT & CUNNINGHAM, *THE ESSAYS*].

<sup>4</sup> Edward B. Rock, *Shareholder Eugenics in the Public Corporation*, 97 *Cornell L. Rev.* 849, 879 (2012) (quoting Buffett's description of Berkshire's goal and strategy to attract "high quality shareholders"); BUFFETT & CUNNINGHAM, *THE ESSAYS*, supra note 2, at 185–188 ("attracting quality shareholders").

<sup>5</sup> See LAWRENCE A. CUNNINGHAM, *QUALITY SHAREHOLDERS*, ch. 3 (2020) (examples of corporate boards boasting quality shareholders as directors including AutoNation, Berkshire Hathaway, Constellation Software, Credit Acceptance Corporation, Enstar, Fairfax Financial, Teledyne, The Washington Post Company) [hereinafter CUNNINGHAM, *QUALITY SHAREHOLDERS*].

<sup>6</sup> Robert N. Palter et al., *Communicating with The "Right" Investors*, in *MCKINSEY ON FINANCE: THE ENDURING VALUE OF FUNDAMENTALS*, 40 MCKINSEY & CO. 57, 58–59 (2011).

influence national productivity and advantages in international markets.<sup>7</sup> An important factor distinguishing U.S. and German systems, for instance, was the long-term focus of German investors (mostly banks) and the quarterly obsession of U.S. investors (especially transients).<sup>8</sup>

In the 1990s and early aughts, Wharton's Brian Bushee enlarged and formalized Porter's insights to classify shareholders by type, which he thought might be useful for future study of shareholder behavior.<sup>9</sup> In pioneering research that's been widely used, Bushee focused on two variables: time horizon (measured by holding periods) and conviction (measured by portfolio concentration).

In the past decade, Martijn Cremers of Notre Dame has explored how funds managed by active quality shareholders outperform those operated as passive index funds.<sup>10</sup> Scholars in both finance<sup>11</sup> and law<sup>12</sup> use this research for many studies, from assessing alternative shareholder voting regimes to dissecting the role and types of shareholder activists, both economic activists and policy activists.

I've written a book<sup>13</sup> and four research articles on this topic,<sup>14</sup> plus many columns;<sup>15</sup> conducted empirical tests and research surveys of governance practices and preferences;<sup>16</sup> founded and run a university

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<sup>7</sup> MICHAEL E. PORTER, *CAPITAL CHOICES: CHANGING THE WAY AMERICA INVESTS IN INDUSTRY*, 42-49 (1994).

<sup>8</sup> Michael E. Porter, *The Competitive Advantage of Nations*, HARV. BUS. REV. (Mar.-Apr. 1990), <https://hbr.org/1990/03/the-competitive-advantage-of-nations>.

<sup>9</sup> Brian Bushee, *Identifying and Attracting the "Right" Investors: Evidence on the Behavior of Institutional Investors*, 16 J. APP. CORP. FIN. 28, 29 (2004) [hereinafter Bushee, *The "Right" Investors*].

<sup>10</sup> Martijn Cremers, *Active Share and the Three Pillars of Active Management: Skill, Conviction, and Opportunity*, 73 FIN. ANALYSTS J. 61 (2017).

<sup>11</sup> E.g., Paul Borochoin & Jie Yang, *The Effects of Institutional Investor Objectives on Firm Valuation and Governance*, 126 J. FIN. ECON. 171 (2017); Brian L. Connelly, Laszlo Tihanyi, S. Trevis Certo & Michael A. Hitt, *Marching to the Beat of Different Drummers: The Influence of Institutional Owners on Competitive Actions*, 53 ACAD. OF MGMT. REV. (2010).

<sup>12</sup> E.g., Lynne L. Dallas & Jordan M. Barry, *Long-Term Shareholders and Time-Phased Voting*, 40 DEL. J. CORP. L. 541, 549 n.6 (2016); Tamara C. Belinfanti, *Shareholder Cultivation and New Governance*, 38 DEL. J. CORP. L. 789, 818 (2014).

<sup>13</sup> See CUNNINGHAM, *QUALITY SHAREHOLDERS*, *supra* note 4

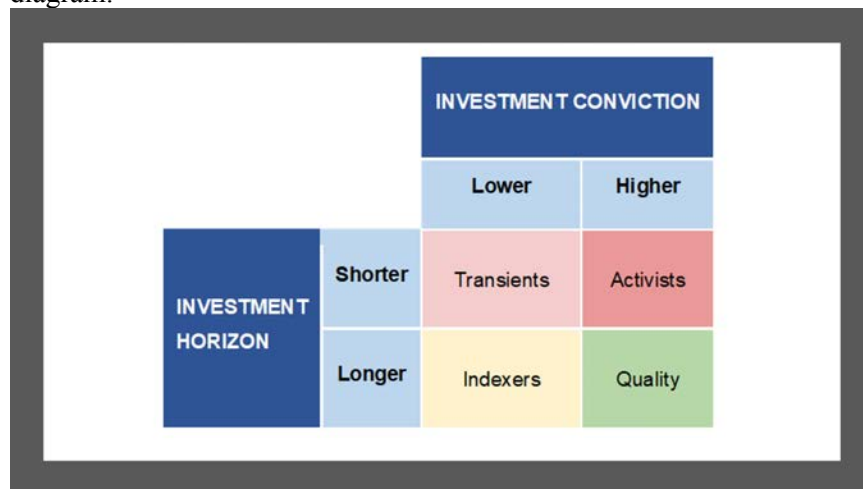
<sup>14</sup> Lawrence A. Cunningham, *Lessons from Quality Shareholders on Corporate Governance Practice, Research and Scholarship*, 5 GEO. WASH. BUS. & FIN. L. REV. 1 (2021); Lawrence A. Cunningham, *Ask the Smart Money: Shareholder Votes by a Majority of the Quality Shareholders*, 55 U.C. DAVIS L. REV. 1019 (2021) [hereinafter Cunningham, *Ask the Smart Money*]; Lawrence A. Cunningham, *Cultivating Quality: How and Why Corporations Attract the Best Shareholders*, 15 OHIO ST. BUS. L. J. 85 (2021); Lawrence A. Cunningham, *The Case for Empowering Quality Shareholders*, 46 BYU L. REV. 1 (2021).

<sup>15</sup> See Lawrence A. Cunningham, *Cunningham's Quality Investing*, MARKETWATCH COLUMNS (2021-22), <https://www.marketwatch.com/column/lawrence-a-cunninghams-quality-investing>.

<sup>16</sup> Lawrence A. Cunningham, *Lessons from Quality Shareholders on Corporate Governance Practice, Research and Scholarship*, 5 GEO. WASH. BUS. & FIN. L. REV. 1 (2021).

research center<sup>17</sup> and a boutique consultancy firm;<sup>18</sup> and been interviewed and cited extensively on the topic.<sup>19</sup>

To visualize these shareholder typologies, consider this 2 x 2 diagram.



Investment Conviction is shown across the top horizontal—from lower to higher portfolio concentration. Investment Horizon is shown down the left vertical—from shorter to longer holding periods. The cohorts are named accordingly:<sup>20</sup>

transients, who may concentrate but are never long term,

<sup>17</sup> GEO. WASH. UNIVERSITY LAW SCHOOL, *Quality Shareholders Initiative*, <https://www.law.gwu.edu/c-leaf-initiatives>.

<sup>18</sup> QUALITY SHAREHOLDERS GROUP, <https://qualityshareholdersgroup.com/>.

<sup>19</sup> See David F. Larcker & Bryan Tayan, *Seven Gaping Holes in Our Knowledge of Corporate Governance*, ROCK CTR. FOR CORP. GOVERNANCE AT STAN. U. CLOSER LOOK SERIES (April 11, 2023), <https://ssrn.com/abstract=4416663>; BRANDES INSTITUTE, *What Makes Quality Shareholder? A Conversation with Lawrence Cunningham*, U. CAL. SAN DIEGO (May 2021), [https://rady.ucsd.edu/\\_files/brandes/long-term-thinking/brandes-institute-quality-shareholders.pdf](https://rady.ucsd.edu/_files/brandes/long-term-thinking/brandes-institute-quality-shareholders.pdf); Consuelo Mack, *Improve Investment Results: Quality Shareholders*, WealthTrack/PBS (August 28, 2021), <https://wealthtrack.com/quality-investing-shareholders-why-warren-buffet-believes-they-produce-better-investment-results>; Tobias Carlyle, *Quality Shareholder: Lawrence Cunningham on Buffett and the QSs*, THE ACQUIRERS PODCAST, [https://www.youtube.com/watch?v=BFTq6fizAHY&ab\\_channel=TheAcquirersPodcast](https://www.youtube.com/watch?v=BFTq6fizAHY&ab_channel=TheAcquirersPodcast); Sean Stannard-Stockton, *Lessons from Quality Shareholders*, ENSEMBLE CAPITAL (Dec. 17, 2021), <https://intrinsicinvesting.com/2021/12/17/lessons-from-quality-shareholders>.

<sup>20</sup> The participants sometimes use different methods and nomenclature to describe similar things: (1) the diverse/passive investors are called indexers, mechanical investors or quasi-indexers—I call them all indexers; (2) short-term holders may be called just that or traders or transients, the term I favor; and (3) the focused long-term cohort has been called high-quality, intrinsic, dedicated—or, as I do, just quality. The intuition behind each label is the same and match Fisher’s restaurant analogy: (1) indexers are like buffet diners, tasting a bit of everything; (2) transients are like fast food lovers, eating on the run; and (3) quality shareholders are gourmands, patiently savoring selected dishes.

activists who may load up but rarely for long, indexers, who may be long term but never concentrate, and quality shareholders who are both concentrated and long-term.

Looking at the investment landscape today, indexers dominate. Though popular only since the 1980s, index funds now hold as much as 40% of public equity.<sup>21</sup>

The indexing cohort is ruled by the big three—BlackRock, State Street and Vanguard—which together control as much as 20% of many large companies.<sup>22</sup> Other indexers rely on the two powerful proxy advisors, ISS and Glass Lewis.<sup>23</sup>

Transients, following the ancient practice of holding stocks for short periods, are also numerous. They reach from 25% to 40% of total public equity, depending on your time cut off defining short-term.<sup>24</sup> Many apply nanotechnology and artificial intelligence to guide their actions, which can increase short-term trading.<sup>25</sup>

Activists are a small but powerful cohort, and increasingly diverse: some focus on traditional shareholder value while others campaign for social or political agendas by using the rights of share ownership.<sup>26</sup>

Quality shareholders make up the rest. They are united by patience, conviction, and a contextual approach to corporate governance and administration.<sup>27</sup> While Warren Buffett is an exemplar,<sup>28</sup> he credits his

<sup>21</sup> Indexing involves buying proportional stakes in every stock listed in some benchmark index, such as the S&P 500 or Russell 3000, without doing any research or being exposed to anything but the market risk-return. Popularized by the late Jack Bogle, indexing was a marginal practice through the 1990s, but today is a familiar approach. Bogle's company, Vanguard, is a household name. Large indexers command trillions of assets, representing one-quarter to one-third or more of total U.S. public company equity. *See generally* Cunningham, *The Case for Empowering Quality Shareholders*, *supra* note 13, at 43–55.

<sup>22</sup> Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019).

<sup>23</sup> James R. Copland, David F. Larcker & Brian Tayan, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry* 7 ROCK CTR. FOR CORP. GOVERNANCE AT STAN. U. CLOSER LOOK SERIES (2018), <https://ssrn.com/abstract=3188174>.

<sup>24</sup> Average holding periods shortened significantly from the mid-1960s through the early- or mid- 2000s. Anne M. Tucker, *The Long and The Short: Portfolio Turnover Ratios & Mutual Fund Investment Time Horizons*, 43 IOWA J. CORP. L. 581 (2018) (through 2000); Paul H. Edelman, Wei Jiang & Randall S. Thomas, *Will Tenure Voting Give Corporate Managers Lifetime Tenure?*, 97 TEX. L. REV. 991, 992 (2019) (through 2007). While the average has held steady since, this appears to be due to how the shorter horizons of many are offset by the more permanent holdings of the indexers. K.J. Martijn Cremers & Simone M. Sepe, *Institutional Investors, Corporate Governance, and Firm Value*, 41 SEATTLE U. L. REV. 387, at n. 42 (2018)

<sup>25</sup> *See* Tom C. W. Lin, *Artificial Intelligence, Finance, and the Law*, 88 FORDHAM L. REV. 531 (2019).

<sup>26</sup> *See* William W. Bratton & Joseph A. McCahery, *Introduction to Institutional Investor Activism: Hedge Funds and Private Equity, Economics and Regulation*, FACULTY SCHOLARSHIP AT PENN LAW, 1–38 (2015), [https://scholarship.law.upenn.edu/faculty\\_scholarship/11645/](https://scholarship.law.upenn.edu/faculty_scholarship/11645/).

Columbia Business School professor, Ben Graham, who taught students to focus on particular companies, not market aggregates.<sup>29</sup> The cohort boasts such other notable historical figures as John Maynard Keynes,<sup>30</sup> along with such legacy names as Bill Ruane or Ruane Cunniff, John Neff of Wellington Management or Thomas Rowe Price and his eponymous firm, T. Rowe Price Group Inc.<sup>31</sup>

Graham and Buffett have influenced millions of investors over several generations, as suggested by the strong sales of books by and about both men. The cohort is today a professional subset within the investment field with their own canonical books, professional associations and designations such as the CFA, successor to the New York Society of Security Analysts that Graham helped to create.

All shareholder cohorts contribute something but also present downsides. Index funds enable millions to enjoy market returns at low cost, but may allocate limited resources or capacity to understand specific company details.

At a typical large index fund, 45 staffers cover 3,000 companies, posing tens of thousands of governance questions every year.<sup>32</sup> Proxy advisors also operate on shoestring budgets, around 1,000 people making recommendations on 100,000 questions annually.<sup>33</sup>

Index funds are concerned most with the performance and size of a portfolio, not specific companies. They therefore have an incentive to prescribe policies expected to benefit the overall stock market on average, not particular companies.

Transients offer liquidity but may add volatility. And compressed shareholder time horizons can induce a short-term managerial view.

Activists focused on shareholder value promote accountability, but some may get carried away occasionally, while policy activists use shareholder rights to advance social or political goals.

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<sup>27</sup> CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 4.

<sup>28</sup> See Amy Deen Westbrook, *Warren Buffett's Corporation: Reconnecting Owners and Managers*, 34 OKLA. CITY U. L. REV. 515 (2009); William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-regulation*, 73 N.C. L. REV. 1861, 1919 & n. 224 (1995).

<sup>29</sup> See LAWRENCE A. CUNNINGHAM, HOW TO THINK LIKE BENJAMIN GRAHAM AND INVEST LIKE WARREN BUFFETT (2001); WARREN BUFFETT, THE SUPERINVESTORS OF GRAHAM AND DODDSVILLE, HERMES (1985).

<sup>30</sup> JOHN F. WASIK, KEYNES'S WAY TO WEALTH: TIMELESS INVESTMENT PRINCIPLES FROM THE GREAT ECONOMIST (2014).

<sup>31</sup> See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 4.

<sup>32</sup> Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2118 n.227 (2019); see Cunningham, *Ask the Smart Money*, *supra* note 13, at 1069.

<sup>33</sup> Copland et al., *supra* note 22 at 2; see Cunningham, *Ask the Smart Money*, *supra* note 13, at 1070–71.



Quality shareholders offset these downsides: [1] they are concerned almost entirely with specific companies, [2] consciously ignore short-term adversity, and [3] tend to prefer quiet engagement focused on shareholder value. The chief downside of quality shareholders is that they can be wrong in their judgments.

### III. GOVERNANCE

With that research framework, let's compare philosophies and approaches to corporate governance. To begin this comparison, start with two cautionary statements about corporate governance:

- pat formulas should be viewed with great skepticism; and
- drastic reforms should simply be opposed.

These appear to be credible reflections of the Delaware philosophy of corporate governance, acknowledging that [1] pat formulas are suspect because one size does not fit all and [2] drastic reforms are dangerous as they tend to overshoot targets and destroy value.

The cautions could have been written today—by me, in fact. But they were written 40 years ago by a legendary Delaware lawyer, Irving Shapiro.

His 1984 book, America's Third Revolution, has a thorough chapter on corporate governance, weighing age-old debates.<sup>34</sup> Shapiro spent most of his career at DuPont, rising through the legal department to become general counsel and later chairman and CEO. Afterwards, when I knew him, he was a partner at Skadden in Wilmington.

In 1984, Irv gave me a signed copy of his book, which I still open from time to time and am ever grateful for his wisdom. I remember how astute his warnings were then and marvel at how apt they remain today. After all, pat formulas and drastic proposals are everywhere in corporate governance nowadays.

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<sup>34</sup> IRVING S. SHAPIRO, AMERICA'S THIRD REVOLUTION (1984).

Starting with the pat formula, consider an 11-pronged approach reflecting a prevailing philosophy of the indexing community.

The board chairman should not be CEO or there should be a lead independent director.
The board should be majority independent.
All standard board committees should have only independent directors.
At least 30% of directors should be other than straight, white, males.
All directors should attend at least 75% of meetings and no director may serve on more than four public company boards.
All directors should face term limits.
All directors should face age limits.
Every director should be elected annually, not every two or three years.
No company should use cumulative voting in director elections.
No company should have classes of stock with different voting or economic rights.
No company should have authorized but unissued preferred stock.

The list is extracted from BlackRock’s guidelines for the 2023 proxy season, which it outlined in a post on Harvard Law’s governance blog.<sup>35</sup> The giant indexer, and others in its cohort, including the proxy advisors, publish such guidelines every year. I’ve long studied them, and they seem to get more prescriptive with each edition.

They contain many more items, but these illustrate the style. They present sharp bright line rules—for independence, diversity, and terms of office—plus clear singular preferences on numerous governance choices. While the firms disclaim that these preferences are inviolate rules, saying

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<sup>35</sup> See Sandy Boss, *Investment Stewardship Proxy voting U.S. guidelines 2023*, HARV. L. FORUM CORP. GOV. (Jan. 18, 2023), <https://corpgov.law.harvard.edu/2023/01/18/investment-stewardship-proxy-voting-u-s-guidelines-2023>.

they examine many topics “case-by-case,” in practice, they take that form.

Compare the BlackRock rules with the Delaware philosophy and approach. Under the DGCL, every one of these provisions can be tailored for a company and all are authorized to go either way.<sup>36</sup> Delaware case law has no general rules or restrictions.<sup>37</sup> Rather, it points to the required fiduciary duties: the duty of loyalty, where independence is relevant,<sup>38</sup> and care, where being fully informed is required.<sup>39</sup>

The Delaware approach is how quality shareholders prefer it.<sup>40</sup> For every element, empirical data and survey results show that quality shareholders disagree with the prescription. They prefer to focus on particular company choices, viewed in context.

According to publications by a number of different quality shareholders, led by Warren Buffett, what they seek most are directors with a shareholder orientation, business savvy, and interest in the particular company and its stewardship.<sup>41</sup> Independence or diversity may be factors, but quality shareholders don’t like fixed percentages and don’t put those factors above a shareholder orientation.

To illustrate, take the first topic listed, of splitting or combining the chair and CEO role. Quality shareholders are just as likely to own large stakes in companies that split these functions as combine them. They understand that in some cases the roles should be split, in others combined.<sup>42</sup>

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<sup>36</sup> *E.g.*, DEL. CODE ANN. tit. 8, § 141(d) (staggered board); § 214 (cumulative voting); § 151(a) (classes of stock with different rights); § 115 (authorized but unissued preferred).

<sup>37</sup> For a famous expression of this sentiment, see *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989) (“there is no single blueprint that a board must follow to fulfill its duties”).

<sup>38</sup> *E.g.*, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703 (Del. 1983); *Singh v. Attenborough* 137 A.3d 151, 153 (Del. 2016); *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304, 311–13 (Del. 2015); *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 653 (Del. 2014).

<sup>39</sup> *E.g.*, *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985); *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114, 122 (Del. 2006). *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009).

<sup>40</sup> See Lawrence A. Cunningham, *Lessons from Quality Shareholders on Corporate Governance Practice, Research and Scholarship*, 5 GEO. WASH. BUS. & FIN. L. REV. 1 (2021).

<sup>41</sup> See Lawrence A. Cunningham, *Warren Buffett’s Ten Commandments for Directors*, *NACD Directorship* (July–August 2017), available at <https://www.cnbc.com/2017/07/17/warren-buffetts-10-commandments-on-boardroom-power-and-success.html>.

<sup>42</sup> Lawrence A. Cunningham, *The Secret Sauce of Corporate Leadership*, WALL ST. J. (Jan. 25, 2015). After all, board chairs get only one vote, so it comes down to the capability of the other directors. Good ones neutralize any conflict. Many corporations thrive when led by an outstanding person as both chair and CEO, while others fail amid split roles—Enron is an example.

On this and all these topics, empirical research on their relation to corporate performance shows there's no single right or wrong answer. The only answer is "it depends." For example, research shows little *if any relationship* between director independence and corporate performance.<sup>43</sup> To the contrary, a board's independence appears to be less important than its active engagement.<sup>44</sup>

Indexers tout evidence of *correlations* between formula elements, such as board diversity, and corporate performance. Yet there's scant evidence that any of these elements is the *cause of* better performance.<sup>45</sup>

Publishing prescriptions like these poses another problem: choices *at first* innocently called *best practices* have a way of hardening, making departures taboo. Stark examples to date include the inexorable rise of independent directors<sup>46</sup> and the abolition of staggered boards.<sup>47</sup>

While prescribed practices are desirable for *some or many* companies, they aren't best for *all* companies. In that way, the contextual approach inspired by Delaware, preferred by quality shareholders, is superior to formulaic governance favored by indexers.

#### IV. THE E AND S IN ESG

Looking at other topics high on the agenda of indexers—the E and the S in ESG—indexers increasingly assert strong opinions and direct the same actions of all boards on many topics. For instance, in the same document released last month, BlackRock, like other indexers, calls for behavior and details on climate risk, key stakeholders, human capital, natural resources and succession planning.<sup>48</sup>

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<sup>43</sup> E.g., Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002); Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 922–23 (1999); Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, FED. RESRV. BANK OF N. Y. ECON. POL'Y REV. 7 (2003).

<sup>44</sup> See Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1317–18 (1998).

<sup>45</sup> Lawrence A. Cunningham, *Board Gender Diversity: Debate and Practice*, 63 CANADIAN BUS. L. REV. 244 (2020).

<sup>46</sup> Lawrence A. Cunningham, *Ask the Smart Money*, *supra* note 13, at 1028–32 (discussing the rise of director independence); see also Lawrence A. Cunningham, *Rediscovering Board Expertise: Legal Implications of the Empirical Literature*, 77 CINCINNATI L. REV. 465 (2008).

<sup>47</sup> Lawrence A. Cunningham, *The Case for Empowering Quality Shareholders*, *supra* note 13, at 39–41 (discussing the debate over staggered boards).

<sup>48</sup> Boss, *supra* note 34.

How to address such weighty matters varies by company, for boards to resolve. Yet BlackRock advises ALL corporate boards that:

- there's a "growing consensus" that companies benefit from a particular energy transition and need a related business plan;
- they should "build strong relationships with key *stakeholders*" because that helps meet other objectives; and
- human capital management is a "critical factor" that "contributes to business continuity, innovation and long-term value creation."

Topics raised in this guidance are important for society, and policy activists increasingly use shareholder rights to pressure companies to pursue related agendas. But a corporation's role in addressing such topics is contestable and variable.

From a director's perspective, all the assertions are mere opinions and each suffers other flaws, especially being one-size-fits-all as well as speculative, presumptuous, acontextual and unnuanced.

Under Delaware law, it's for directors of a particular company to determine, under the protections of the business judgment rule, [1] whether a "growing consensus" exists on a topic, [2] whether to join or challenge that consensus and [3] whether a corresponding business plan is necessary or appropriate.

As the Delaware Supreme Court noted in *Brehm versus Eisner*, it's also for directors, not shareholders, to determine whether to follow governance practices seen as "good," "desirable" or "beneficial."<sup>49</sup> As emphasized in cases such as *Caremark*<sup>50</sup> and *Stone v. Ritter*,<sup>51</sup> evaluating fiduciary oversight obligations requires context, pivoting on questions of "good faith" and "reasonableness," not a place for one-size-fits-all.

#### V. THE SEC

Federal securities regulators are inclined not only to pat formulas, but to incursions into corporate governance that's long been the province of state law. Influenced by the indexing community and other advocates,

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<sup>49</sup> 746 A.2d 244, 257–58 (Del. 2000) ("Aspirational ideals of good governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability.").

<sup>50</sup> 698 A.2d 959 (Del. Ch. 1996).

<sup>51</sup> 911 A.2d 362 (2006).

the regulators are pursuing a one-size *and intrusive* approach to corporate governance.

Prominent examples appear in the SEC's proposed regulations on cybersecurity<sup>52</sup> and on climate change.<sup>53</sup> Both call for detailed information about a company's related risks, *potentially* relevant to the SEC's statutory mandate over national securities markets and investor protection.<sup>54</sup>

But both also intrude into board governance and practices.<sup>55</sup> They would require details on board responsibilities and expertise in these subjects, how the board processes related information, how often directors discuss these topics, and how boards relate these topics to other corporate affairs.

Delaware imposes no such specific requirements or blueprints. It relies instead upon general standards of fiduciary duty that recognize context. They let different boards operate according to the best interests of their corporations—all with deference under the business judgment rule.<sup>56</sup>

Such unitary intrusions, from both regulators and indexers, probably qualify as “pat formulas” warranting “great skepticism,” as Irv Shapiro advised, and certainly approach “drastic reforms” that he advised opposing “in toto.”

## VI. SOCIAL

For a clearer example of both pat and drastic, consider pressure to compel companies to issue mission statements emphasizing a social dimension and demands that CEOs speak out on social issues. Infamous for exerting such pressure is again BlackRock, through its CEO, Larry Fink. He writes an annual open letter to America's CEOs telling them

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<sup>52</sup> Cybersecurity Risk Management Rule for Broker-Dealers, Clearing Agencies, Major Security-Based Swap Participants, the Municipal Securities Rulemaking Board, National Securities Associations, National Securities Exchanges, Security-Based Swap Data Repositories, Security Based Swap Dealers, and Transfer Agents, File No. S7-06-23 (proposed Mar. 15, 2023) (to be codified at 17 C.F.R. pts. 232, 240, 242 & 249).

<sup>53</sup> The Enhancement and Standardization of Climate-Related Disclosures for Investors, File No. S7-10-22 (proposed Mar. 21, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 239 & 249).

<sup>54</sup> See Lawrence A. Cunningham et al., *The SEC's Misguided Climate Disclosure Rule Proposal*, 41 BANKING FIN. SERVS. POL'Y REP. 1 (2022).

<sup>55</sup> See Lawrence A. Cunningham, *Why the “Special Interest Director” is a Bad Idea for Cyber, Climate or Otherwise*, LEXOLOGY (April 18, 2023), <https://www.lexology.com/library/detail.aspx?g=1f86c2d1-7401-4faa-b697-8e0d36dc903c> (adapted version to appear in the OXFORD LAW BLOG).

<sup>56</sup> See Henry Ridgely Horsey, *The Duty of Care Component of the Business Judgment Rule*, 19 DEL. J. CORP. L. 971 (1994).

how they and their boards must behave. A sampling of these controversial but influential missives:

- amplifying earlier calls for mission statements, the 2018 letter says boards must review and companies must publicize a written strategic framework which must show an understanding of the company’s societal impact.
- in 2019: companies must demonstrate their commitment to communities where they operate on issues “central to the **world’s** future prosperity.”
- 2020, after prescribing extensive “sustainability” disclosure, warning that BlackRock doesn’t support directors of companies lacking such disclosure—pointing to “4800 directors at 2700 companies”
- 2022: CEOs must speak publicly on where they “stand on societal issues”

But nothing in law, business or logic requires companies to adopt any such written statements, let alone ones like that, or for CEOs to take any such public positions.

To the contrary, it’s up to individual CEOs and boards to determine whether and how a company might speak on public issues. Many may wisely determine it’s in their company’s best interests not to do so. Recent boardroom debacles at Disney show the dangers in this area warranting attention to context.<sup>57</sup>

Rather than one-size-fits-all, each board and CEO determine what’s in the best interests of their company and its shareholders. They could use a framework to name some topics the CEO is authorized to speak freely on (such as wages or employee relations) and others that are off limits (such as endorsing candidates for public office) while deciding others according to their relevance to the corporation’s business.<sup>58</sup>

SAMPLE BOARD-CEO FRAMEWORK FOR PUBLIC COMMENT

<sup>57</sup>  
*outside of*  
 chapek-flc  
<sup>58</sup>  
 Directors  
 Comments  
<https://www.lexology.com/library/detail.aspx?g=078992fc-03cc-4e7>  
 reprinted in CORP. GOVERNANCE MONITOR (May 2023).

Off limits

Endorsing given candidates for office

Endorsing or opposing specific political parties or agendas

de and  
 Disney-  
 2022,  
 CEO  
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 ac,

**SAMPLE BOARD-CEO FRAMEWORK FOR PUBLIC COMMENT**

CEO discretion	Hot topics within the company's business	Hot topics outside company's business	Off limits
Wages/employee relations generally	Pandemic screening for airlines (Delta, United), hotels (Hilton, Marriot)	Federal travel ban targeting Muslim-majority countries	Endorsing given candidates for office
Prices/customer relations generally	Soda tax legislation for beverage companies (Coca-Cola, Pepsi)	Federal gun laws to reduce mass shootings	Endorsing or opposing specific political parties or agendas
Earnings/shareholder relations generally	Environmental legislation for renewable energy companies, electronic vehicle makers (Ford to Tesla)	Abortion (e.g., the <i>Dobbs</i> decision)	
Community and charitable relations		Transgender rights/teachings (Florida law) Voting laws (Georgia)	

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Turning to mission statements, BlackRock expects every company to have one and all to stress social aspects. But this ignores the great diversity of opinion about the utility and appropriate scope of corporate mission statements.

Some business leaders swear by corporate credos as guides to behavior. But many worry that they freeze a culture, stunting healthy evolution. Still others note that words are cheap, and many mission statements ring hollow.

Enron, that fantastic fraud, had a mission statement boasting the loftiest values, including respect for others under the Golden rule, and integrity comprised of being open, honest and sincere.

Other companies historically adopting mission statements have expressed a range of priorities. These span from a commitment to dedicated stewardship of shareholder capital at Berkshire Hathaway to saving the earth at Patagonia and the concept of “performance with a purpose” at PepsiCo.<sup>59</sup>

Perhaps the most famous is that of Johnson & Johnson, dating to 1943, noted for the hierarchy of its priorities: customers; employees; communities; and then stockholders. The philosophy reflects a commonsense view of business long associated with Ben Franklin, doing

<sup>59</sup> Patagonia is a B-Corporation, which raises another important point about Delaware’s made to measure approach and the one-size-fits-all approach. Delaware has always been innovative and responsive in corporate law, both on the statutory and judicial fronts. In 2013, for example, it was in the early wave of states enacting public benefit corporation statutes, allowing companies to adopt a particular benefit purpose aside from shareholder interest. Such an alternative should moot much of the debate over corporate purpose concerning the traditional Delaware corporation, but it has not.



well by doing good: doing good by the other constituencies is the path to doing well for shareholders.

In response to the new demands for mission statements tied to social interests, many companies copied the J&J credo. In 2019, the Business Roundtable did so in one fell swoop. Nearly 200 CEOs embraced the J&J credo, as a trade group.<sup>60</sup> They said their individual companies served their own corporate purpose, but all shared the “fundamental commitment to all stakeholders.”

Aside from a one-size-fits-all mission statement for nearly 200 corporations, the associated fanfare sparked fresh conversations on an old topic: whether a for-profit corporation’s purpose is primarily to benefit shareholders, stakeholders, or some combination.

Extremists paint a stark choice—akin to pitting Karl Marx against Adam Smith: some oppose any form of shareholder primacy while others oppose any balancing of contending interests. But many seem to agree with the tradition that lies behind J&J’s original intention dating to Ben Franklin and reflected by distinguished corporate leaders ever since, from Henry Heinz to Warren Buffett and our old friend Irv Shapiro.<sup>61</sup>

Such an approach reflects Delaware corporate law, which is both constraining and liberating. The director’s fiduciary duties of care and loyalty require acting in the best interests of the corporation and its shareholders.

That accommodates, but does not elevate, the interests of other constituents. It facilitates a practical middle ground where companies invariably operate. After all, companies don’t sacrifice employee interests to add pennies to profits, but nor do they continue staffing operations showing endless losses.

While many in the ESG movement earnestly believe that its agenda promotes shareholder interests, there are those who would repudiate the shareholder interest in favor of environmental causes and social justice achievements. Policy activists often do just that by becoming shareholders and exercising related rights.

The SEC, again wading into state law prerogatives, is helping them by granting them the right to require companies to include social proposals on corporate proxy statements. Historically, companies could omit shareholder proposals pushing broad social policy agendas unrelated to a company’s business. But since last year, anything having to do with society must go on the ballot.<sup>62</sup>

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<sup>60</sup> See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 4, at 219–220 (juxtaposing the two statements).

<sup>61</sup> See CUNNINGHAM & BUFFETT, THE ESSAYS, *supra* note 2, at 49 (Buffett positioning himself as between Smith and Marx).

In evaluating whether a company can exclude a shareholder proposal, the SEC staff says they will disregard the “nexus between a policy issue and the company” and instead focus on “the social policy significance of the issue.”

#### VII. OLD TENSIONS AND THE DELAWARE GUARDRAIL

We’ve seen variations on such tensions throughout modern corporate history:

- the famous Berle-Dodd debate of the 1930s asked whether corporations are primarily economic or social institutions<sup>63</sup>
- many fought throughout the 1960s and 70s over the relative merits of markets versus regulation, with polar positions represented by Milton Friedman and Ralph Nader<sup>64</sup>
- in the 70s and 80s, scholars argued over whether corporations should continue to be chartered at the state level or whether federal law should preempt them—SEC chair William Cary pushing to preempt Delaware with Judge Ralph Winter defending the state.<sup>65</sup>

A recurrent pattern appears: related movements usually achieve gains, followed by setbacks and a return to a more centrist position. For example, during the takeover fights of the 1980s, many of which played out here in Delaware, raiders stressed “shareholder value,” while embattled targets lobbied to consider “other constituencies,” especially employees and communities.<sup>66</sup>

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<sup>62</sup> SEC Staff Legal Bulletin No. 14L (CF), (Nov. 3, 2021) (rescinding Staff Legal Bulletin Nos. 14I, 14J and 14K).

<sup>63</sup> A. A. Sommers, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33, 36–37 (1991),

<sup>64</sup> Compare Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), with RALPH NADER, TAMING THE GIANT CORPORATION (1976), and Ralph Nader, *Introduction* to JAMES PHELAN & ROBERT POZEN, THE COMPANY STATE: RALPH NADER’S STUDY GROUP REPORT ON DUPONT IN DELAWARE (1973).

<sup>65</sup> Compare William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1974), with Ralph Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 252, 258 (1977). See also Lyman Johnson, *Sovereignty over Corporate Stock*, 16 DEL. J. CORP. L. 485, 501–519 (1991) (discussing the two and the debate); Roberta Romano, *The State Competitions Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); William T. Quillen, *The Federal-State Corporate Law Relationship: A Response to Professor Seligman’s Call for Federal Preemption of State Corporate Fiduciary Law*, 59 BROOK. L. REV. 107 (1993).

<sup>66</sup> James J. Hanks, Jr., *Playing With Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97, 99 (1991); John H. Matheson & Brent A. Olson, *Shareholder*

The constituencies movement became powerful. Many states passed “constituency statutes”—although not Delaware. But by ultimately trying to put the interests of such constituents ahead of the rights of shareholders, advocates overplayed their hand and lost the cause.

Amid those battles, the Delaware Supreme Court contributed pivotal, pragmatic, clarity. It stressed that directors may consider such other interests, but only if those are “rationally related to shareholder interests,” which held priority. Justice Moore’s landmark *Revlon* opinion was a guardrail against activism veering off the track.<sup>67</sup>

Today, all those tensions are back . . . and rising. Proponents of the social and stakeholder conceptions of the corporation are raising the temperature and opponents are stoking a widely publicized backlash.

With such stakes, it’s easy to imagine cases reaching Delaware courts, if they haven’t already.

#### VIII. ESG IN DELAWARE

Coming issues might include the role of shareholder views on one-size-fits-all best practices, the *Caremark* duty of oversight spanning spheres from the workforce to the supply chain, or a board decision starkly trading shareholder interests for environmental or social priorities.<sup>68</sup>

Today, boards and shareholders enjoy wide freedom to define governance, but boundaries remain. While Delaware corporate law almost never prescribes governance arrangements or “blueprints” for board action, Delaware—all of you—continue to provide important and necessary guardrails, anchored in the Delaware way.

I’ll conclude by returning to Irv Shapiro again—in words that are as true today as when he wrote.

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*Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1520, 1540–45 (1991)

<sup>67</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (a board’s concern for other constituencies (the noteholders) was not “rationally related [to] benefits accruing to the stockholders” and was “inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.”)

<sup>68</sup> A drastic version of that question may appear in a strange complaint alleging that director fiduciary duties should now be geared solely towards indexers and their portfolios rather than a company’s shareholders as company shareholders. *See Amended Complaint at 2–5, McRitchie v. Meta Platforms, Inc.*, 2023 WL 1861619 (Del. Ch. Feb. 7, 2023) (C.A. No. 2022-0890-JTL).

Delaware leads in corporate chartering service because the DGCL is “modern and fair” and because Delaware judges [inspire] confidence in the “stability and wisdom of the Delaware courts.”

But Delaware doesn’t tell companies which directors to choose or qualifications to have. Nor does the state seek to use charters as weapons for regulating companies in new ways.

Shareholder demographics change, along with fashions in the philosophy of corporate governance. But the DGCL’s appeal, and the Delaware judiciary’s inspiring leadership, are enduring. Please keep up the good work, Delaware, whatever comes down the docket, as the country, not least its quality shareholders, are counting on you.