Deconstructing Shareholder Climate Activism: Why Institutional Investors Are Bullying Carbon Majors

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Madison Condon, *Externalities and the Common Owner*, 95 **Wash. L. Rev**. 1 (2020), available at SSRN.

At Chevron's 2020 annual meeting, a majority of voting shareholders approved a resolution urging the oil giant to bring its lobbying efforts in line with the Paris Climate Agreement's goal of limiting global warming to two degrees Celsius. What seemed like a pipe dream not long ago has become a fixture on Wall Street. Climate activism has emerged as a dominant theme at shareholder meetings in the energy sector and beyond, with some resolutions receiving nearly sixty percent of votes. In her excellent article, *Externalities and the Common Owner*, Professor Madison Condon draws on modern portfolio theory to offer an intriguing explanation for the changing tide in shareholder climate activism.

In recent years, concerned shareholders have garnered majority approval for resolutions calling for corporate emission reduction targets, better disclosure of climate risk, and suspension of lobbying against carbon regulation, among other climate action – often against the vocal opposition of the company's own board. This surge in shareholder support for climate-related proposals is likely the product of a multitude of factors, including the growing sense of urgency surrounding global climate change. Professor Condon makes a compelling case that a key driver of shareholders' newfound love for climate activism may be a paradigm shift in the approach of institutional investors to corporate governance.

Along the way, Professor Condon incisively slaughters not one, but two sacred cows of the corporate governance literature. First up, the general assumption that rational shareholders will exercise their governance rights to maximize the firm's value. Condon persuasively lays out the inherent conflict (at least in the near term) between the corporate objective of profit maximization and a shareholder-driven commitment to voluntary emission reductions, even more so when such a commitment is to be adopted by carbon majors like Shell, Total, or Chevron. The second bovine casualty of the article's sharp analysis is the widely held belief that broadly diversified institutional investors are "rationally reticent" to invest their time and effort in corporate governance. After all, portfolio diversification tends to produce relatively small stakes in individual companies so the significant costs of shareholder engagement would translate to only small returns to the diversified investors' portion of ownership. And yet, recent proxy seasons offer ample evidence of climate activism by pension funds, insurance companies, mutual funds, and other institutional investors bullying big oil and other carbon majors into climate action. So what gives?

The answer flows indirectly from Einer Elhauge's observation that the proliferation of institutional investment has reduced market competition as key companies are increasingly owned by the same large shareholders. Since 1950, the share of institutional ownership in U.S. equities has grown from little over 5% to nearly 80%. Today, there is a more than 90% chance that any two competing firms in a given industry share at least one large shareholder that holds a stake of five percent or more in both companies – a more than fivefold increase compared to 1994. As Elhauge and others hone in on the anti-competitive effects of such "horizontal shareholding," Professor Condon adds a novel climate dimension to the discourse.

Externalities and the Common Owner crafts a compelling argument that BlackRock, CalPers, Vanguard, and other "universal owners" have a strong financial incentive to advance corporate governance that will "mitigate climate change risks and damages to their economy-mirroring portfolios." These broadly diversified institutional investors are willing to accept the negative short-term impacts of climate activism on the bottom line of individual firms if their engagement helps reduce systemic climate risk sufficiently to avert, or at least mitigate, damage to their other portfolio holdings. To illustrate this paradigm shift from the traditionally firm-centric to a portfolio-maximizing shareholder governance strategy, Professor Condon cites to several investor declarations revealing a growing emphasis on portfolio returns. She also offers an intuitive back-of-the-envelope calculation comparing costs and benefits using William Nordhaus's acclaimed Dynamic Integrated Climate Economy Model. Based on Condon's math, a broadly diversified investor like BlackRock with significant stakes in Exxon and Chevron might lose over $6 billion by supporting shareholder resolutions that force a 40% reduction in the two companies' greenhouse gas emissions. But these losses would be more than compensated by the nearly $10 billion in damages from climate change that the emission reductions would avert from the rest of BlackRock's portfolio.

Having laid out the economics of institutional investors' externality-internalizing strategy of portfolio maximization, Professor Condon surveys the various avenues for influencing corporate officers, from shareholder proposals and board elections to informal communication and compensation. Next, she explores how sacrificing individual firm profits and value in the interest of portfolio returns may violate fiduciary duties owed by both firm managers and investment managers. Against this background, Professor Condon translates her observations and argument into a convincing amendment of the traditional narrative of institutional investors' rational reticence to exercise their corporate governance rights.

The final section of *Externalities and the Common Owner* explores some of the broader normative issues presented by the portfolio-maximizing strategy of diversified institutional investors. Professor Condon ponders whether the net welfare gains from climate and other pollution reduction benefits will be enough to outweigh the negative welfare impacts from reduced competition and monopsony pricing in labor markets. A separate line of inquiry explores challenges related to the democratic legitimacy and accountability of a small group of heavyweight investors privatizing the kind of environmental governance choices traditionally left to governments and their elected officials. The author concludes that "[t]he net welfare effects of common ownership require further study, but intuition suggests this behavior is not aligned with aggregate social welfare." (P. 79.)

Whether your scholarly interests lie in corporate governance, climate policy, or anywhere in between, *Externalities and the Common Owner* is a must-read. Professor Condon provides a deeply thought-provoking account of the evolving role of institutional investors in the war on carbon, while charting an intriguing agenda for future research on the benefits and drawbacks of portfolio maximization approaches to shareholder engagement.

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