

Spring 2-15-2021

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Recommended Citation

Lawrence A. Cunningham, *The Case for Empowering Quality Shareholders*, 46 BYU L. Rev. 1 (2021).
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The Case for Empowering Quality Shareholders

Lawrence A. Cunningham*

Anyone can buy stock in a public company, but not all shareholders are equally committed to a company's long-term success. In an increasingly fragmented financial world, shareholders' attitudes toward the companies in which they invest vary widely, from time horizon to conviction. Faced with indexers, short-term traders, and activists, it is more important than ever for businesses to ensure that their shareholders are dedicated to their missions. Today's companies need "quality shareholders," as Warren Buffett called those who "load up and stick around," or buy large stakes and hold for long periods.

While scholars in recent years have extensively debated indexers, short-term traders, and activists, they have paid scant attention to quality shareholders and their critical role in corporate finance and governance. This Article corrects this oversight by highlighting the quality shareholder cohort. Adding this fresh perspective confirms some of the angst about myopic short-termism on the one hand and ignorant indexing on the other, but rather than suggesting tighter regulation of such behaviors, the reframing invites attention to empowering quality shareholders. In particular, rather than taxing short-term shareholders or passing through indexer voting rights, this Article explains how companies could simply increase the voting power of their quality shareholders to recognize their value and to attract them.

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INTRODUCTION

The growing size and power of institutional investors is among the most important contemporary trends in American corporate life.¹ In recent years, their rise has drawn special attention to shareholder activists on the one hand and passive index funds on the other. Lively debates address whether such powerful investors have the right vision or conviction to faithfully discharge the trust so many Americans have placed in them.

Regarding vision, for two decades scholars have debated whether investors, especially activists, are too short-term oriented for markets and managers to maintain a long-term view.² Regarding conviction, just in the past two years scholars began to debate whether certain kinds of investors, particularly passive indexers, have sufficient incentives to actively monitor managers to assure performance over any horizon.³ In a related debate on shareholder voice in corporate affairs, some scholars propose reducing the voting power of short-term shareholders to encourage long-term thinking while others propose eliminating that of indexers due to their passivity.⁴

1. See John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* (Sept. 20, 2018) (unpublished manuscript), www.ssrn.com/abstract=3247337 (The trend of rising power of institutional investors increases “the likelihood that in the near future roughly twelve individuals will have practical power over the majority of U.S. public companies.”).

2. See generally Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (arguing for increased shareholder power); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) (responding to and disagreeing with Bebchuk); William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010) (arguing that increased shareholder power would increase agency costs); Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554 (2015) (challenging the tendency to favor long-term investors over short-term investors).

3. Compare Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019) (agency cost indictment of indexer capability), with Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17 (2019) [hereinafter Fisch et al., *The New Titans*] (ringing theoretical defense of indexer capability).

4. See Paul H. Edelman, Wei Jiang & Randall S. Thomas, *Will Tenure Voting Give Corporate Managers Lifetime Tenure?*, 97 TEX. L. REV. 991 (2019); Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018); David J. Berger, Steven Davidoff Solomon & Aaron J. Benjamin, *Tenure Voting and the U.S. Public Company*, 72 BUS. LAW. 295 (2017).

These are vital debates in corporate America, implicating fundamental questions of the balance of power between directors and shareholders as well as among shareholders. As such, they stoke numerous sub-debates on every aspect of corporate governance, such as board structures, director-officer relationships, and shareholder rights.⁵ Participants see wide-ranging effects on the national economy.⁶

Although such debates are sophisticated, increasingly data-driven, and involve overlapping participants, a peculiar binary characterizes the first two that afflicts the third. The horizon debate juxtaposes short-term against long-term visions but mutes the issue of conviction, while the conviction debate juxtaposes passive against active investment styles while muting the issue of horizon. Hence in the voting debate, there are calls to limit the voting power of either short-term shareholders or indexers, but not both.⁷

In fact, while time horizon and relative conviction are vital, neither taken alone captures the nuanced reality of investor behavior, which, at a minimum, calls for examining both features simultaneously. This Article proposes to incorporate such concurrent analysis of horizon and conviction into all three of these corporate law debates. By switching from binary conceptions to one that combines both attributes, analysis permits recognizing another cohort of shareholders whose role has been missing in all three debates: long-term concentrated shareholders.

While contemporary data suggest that a large plurality of institutional shareholders qualify as short-term and another plurality as indexers, the long-term concentrated cohort remains a significant force in market and corporate behavior.⁸ It should accordingly have an important place in debates over horizon, conviction, and voting.

This Article draws on related literature in finance and accounting, cited in these corporate law debates, delineating

5. See *infra* Section II.C.

6. See, e.g., Berger et al., *supra* note 4, at 307–09.

7. See *infra* Part IV.

8. See LAWRENCE A. CUNNINGHAM, QUALITY SHAREHOLDERS (forthcoming Columbia University Press 2020) (manuscript at 95–116) (on file with BYU L. Rev.) [hereinafter CUNNINGHAM, QUALITY SHAREHOLDERS].

multiple shareholder types based on both horizon and conviction.⁹ To visualize the combined model, blended shareholder cohorts can be identified using a 2 × 2 diagram arraying investment conviction across the top and investment horizon down the side to reveal combinations of conviction and horizon.

		INVESTMENT CONVICTION	
		Lower	Higher
INVESTMENT HORIZON	Shorter	Transients	Activists
	Longer	Indexers	Quality

To animate the approach, descriptive names are assigned: *transients* to shorter-term diversifiers; *indexers* to longer-term diversifiers; *activists* to shorter-term concentrators; and *quality* to longer-term concentrators. Investment conviction is measured by the degree of an investor's portfolio diversification versus concentration, with lower conviction meaning the most diversified portfolio—epitomized by index investors.¹⁰ Investment horizon is measured by the investor's average holding period in its investments.¹¹

In corporate law scholarship, the horizon debate considers shorter versus longer investment horizons (lower left panels of the

9. Brian Bushee, *Identifying and Attracting the "Right" Investors: Evidence on the Behavior of Institutional Investors*, 16 J. APPLIED CORP. FIN. 28, 29 (2004) [hereinafter Bushee, *The "Right" Investors*]; see Lynne L. Dallas & Jordan M. Barry, *Long-Term Shareholders and Time-Phased Voting*, 40 DEL. J. CORP. L. 541, 545 n.6 (2016).

10. See generally Martijn Cremers, *Active Share and the Three Pillars of Active Management: Skill, Conviction and Opportunity*, 73 FIN. ANALYSTS J. 61 (2017) (discussing conviction in the context of active investment management).

11. See Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 ACCT. REV. 305, 309, 330 (1998) [hereinafter Bushee, *Myopic R&D*].

graph), while the conviction debate considers lower versus higher investment concentration (upper right panels in the graph). Combining the two would shift the terms of debate from two pure binaries to an interactive quadrant (lower right panels of the graph). Three immediate normative consequences follow.

First, adding conviction to the horizon debate would unlock stalemates on fundamental issues addressing allocation of power between management and shareholders. In recent years, after two decades of intense discussion, the empirical evidence concerning whether short-termism is problematic remains inconclusive.¹² The empirical uncertainty, however, may be the literature's tendency to overlook significant differences among investors in their relative concentration, not merely time horizons. It may be that short-term traders who also concentrate offset other perceived problems of short-termism. Segmenting quality shareholders in research could help to inform sub-debates on particular governance topics, such as board structures and director-manager relations.¹³

Second, including horizon in the indexing debate will illuminate equally fundamental issues about the allocation of power among shareholders. The literature has tended to compare and contrast passive indexers on the one hand with all other shareholder types as a whole, collectively dubbed "active."¹⁴ This tendency overlooks distinctions among the active cohort, lumping together activists, transients, and quality shareholders. Indexers may well engage too little, but so might transients, perhaps warranting giving quality shareholders a special place in corporate decision making. Likewise, transients may compare themselves to annualized index benchmarks, but quality shareholders do not, focusing instead on long-term results.¹⁵

That leads to the third and most specific implication, concerning shareholder voting. Combining shareholder conviction and shareholder time horizon opens new approaches to this ultimate feature of the debates' normative implications. To date, critics of short-termism prescribe enhanced voting rights for long-

12. See Assaf Hamdani & Sharon Hanes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971 (2019) (symposium issue on the horizon debate); Elisabeth de Fontenay, *The Myth of the Ideal Investor*, 41 SEATTLE U. L. REV. 425 (2018) (symposium issue on the horizon debate).

13. See *infra* text accompanying notes 189–203.

14. See *infra* text accompanying note 207.

15. See *infra* text accompanying notes 106–09.

term shareholders in order to encourage longer time horizons, while critics of indexers prescribe excluding indexers from voting on the grounds of their passivity and ignorance; opponents of both have pushed back accordingly.¹⁶

The critics in both such sub-debates may both be right to propose reducing the power of transients and indexers, respectively. But the logic of combining the two critiques identifies a third way: voting rules that reward longevity and conviction. Call it quality voting. It is the clearest and most important example of the many aspects of these three debates that would change by analyzing investor horizon and conviction in combination.

The stakes are high, as these debates touch fundamental issues in corporate governance. With the rise of institutional investors has come increasing shareholder voice on a wide range of matters, from director elections to say on executive pay and influence on corporate proposals spanning from climate change and gender diversity to strategic direction and corporate priorities. This Article is the first to offer a comprehensive view of quality shareholders, pointing to how their role should reshape these three debates. It proceeds as follows.

Part I presents the quadruple (2 x 2) typology of shareholder cohorts based upon time horizon and relative concentration. These are the recognized categories in the broader literature, and the two that dominate the respective debates on horizon and conviction. However, this discussion focuses not on the activist or indexer – well covered in the literature and reconsidered in ensuing Parts – but on the quality shareholder. While the quality shareholder is well described elsewhere in corporate law scholarship, and more broadly in financial scholarship and general media, it has been virtually ignored in the corporate law debates on horizon, conviction, and voting.

In the wider literature, the exemplars of quality shareholders are Warren Buffett and his company, Berkshire Hathaway. With a pedigree dating back to John Maynard Keynes and a following today commanding several trillions of dollars in invested assets, this cohort is vital. Its distinguishing features are a long-term view and concentrated portfolios, in stark contrast to transients and indexers. Part I introduces these investors, profiles their behavior,

16. See *infra* Part IV.

and demonstrates their competitive position and enduring force in the marketplace.¹⁷

Part II reviews the horizon debate. In thumbnail fashion, given the age and extent of this debate, it outlines the theoretical positions, empirical data, and normative legal implications. It then expands upon the quadruple classification scheme and how adding this approach can reinvigorate the horizon debate. While scholars cannot agree on whether short-termism is a problem, critics who believe it is may be comforted by the force of quality shareholders, and defenders of the status quo may appreciate how such a contrast underscores additional limits of short-term behavior. This Article illustrates the effects of adding quality shareholders using sub-debates over staggered boards and splitting versus combining the roles of board chairman and CEO.

Part III reviews the conviction debate. In somewhat more detail, given the nascent stage of this debate, it reviews the positions, data, and upshot. As a critique of the current literature's focus on indexers versus all others (habitually called "active"), this Part delineates the active cohort further. Among lessons that are uncovered, scholars focus on formulaic incentive models that assume all "active" funds measure themselves against annual index benchmarks or growth in assets under management,¹⁸

17. Among corporate law professors, I may be uniquely suited to elaborate on Buffett and this cohort, having spent nearly three decades immersed in their ecosystem and publishing numerous articles and books about them. See Stephen M. Bainbridge, *Larry Cunningham's Latest Book on Warren Buffett Coming Soon*, PROFESSORBAINBRIDGE.COM (July 21, 2014, 10:22 AM), <https://www.professorbainbridge.com/professorbainbridge.com/2014/07/larry-cunninghams-latest-book-on-warren-buffett-coming-soon.html> ("Few people have done a better job of chronicling Warren Buffett's illustrious career than Law Professor Lawrence Cunningham. . . . I've read all of [his] Buffett books and have found each to be highly entertaining and informative."). Work dates to the mid-1990s when I organized a law review symposium featuring twenty-five corporate law professors dissecting my collection of Buffett's writings. See Lawrence A. Cunningham, *Conversations from the Buffett Symposium*, 19 CARDOZO L. REV. 719 (1997); WARREN E. BUFFETT, *THE ESSAYS OF WARREN BUFFETT: LESSONS FOR CORPORATE AMERICA* (Lawrence A. Cunningham ed., 5th ed. 2019) [hereinafter BUFFETT, *THE ESSAYS*]. Recent articles include Lawrence A. Cunningham, *Berkshire's Disintermediation: A Managerial Model for the Next Generation*, 50 WAKE FOREST L. REV. 509 (2015); Lawrence A. Cunningham, *Berkshire's Blemishes: Lessons for Buffett's Successors, Peers, and Policy*, 2016 COLUM. BUS. L. REV. 1 (2016). Recent books include LAWRENCE A. CUNNINGHAM, *BERKSHIRE BEYOND BUFFETT: THE ENDURING VALUE OF VALUES* (2014); LAWRENCE A. CUNNINGHAM & STEPHANIE CUBA, *MARGIN OF TRUST: THE BERKSHIRE BUSINESS MODEL* (2020).

18. See *infra* text accompanying notes 216–20.

whereas quality shareholders put no stock in such references.¹⁹ The result is that current research ignores the relevant incentives and must be expanded in order to increase its relevance and reliability.

Part IV turns to shareholder voting implications. This is the most obvious topic requiring updating to incorporate quality shareholders. After all, one upshot of the horizon debate is revived interest in voting power based on holding periods (“tenured voting”); one upshot of the conviction debate is new interest in reducing indexer voting power. Logic dictates considering voting rules that do both by increasing the voting power of quality shareholders.

Amid the fragmentation of the shareholder base and related debates, for instance, dual class voting structures have proliferated to insulate companies from pressures of shareholder activists.²⁰ Tenured voting has been advocated as a way to discourage short-term shareholdings,²¹ while exclusionary voting is being proposed to dilute the voice of indexers, seen to lack requisite incentives or knowledge.²² All such proposals are reasonable responses to perceived imbalances. But they are all incomplete and point to the validity of a more complete shareholder voting protocol, one based on both central behavioral tendencies of horizon and conviction.²³

It is sometimes difficult to map theory onto practice, given the constraints of their different realms.²⁴ This reality may partially explain why the quality shareholder cohort has not received the attention it should: it has been relatively easy to model and measure the incentives and profiles of activist shareholders and index funds, while the quality shareholder cohort contains more numerous and idiosyncratic members. But by providing a behavioral profile along with data about their performance and roles, this Article offers the promise of theorizing the practice.

19. See *infra* text accompanying notes 106–09.

20. See *infra* Section IV.A.

21. See *infra* Section IV.B.

22. See *infra* Section IV.C.

23. See *infra* Section IV.D.

24. See Louis Lowenstein, *Efficient Market Theory: Let the Punishment Fit the Crime*, 51 WASH. & LEE L. REV. 925, 925 (1994); Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 639 (2003).

I. QUALITY SHAREHOLDERS

This Part reviews the rise of the institutional investor industry, noting legal scholarship reviewing it and ensuing shareholder fragmentation. It reviews attempts to classify this fragmented shareholder base, highlighting one that delineates according to normatively significant dimensions of both horizon and conviction. The combination introduces a new shareholder cohort to longstanding corporate law debates: the quality shareholder. Its behavioral attributes are explained, along with the cohort's competitive position, its relative performance, and the advantages this approach offers to companies and fellow investors.

A. Fragmentation

In decades past, most shareholders were individuals. In 1965, for example, institutional investors held \$436 billion of \$1.4 trillion in total market capitalization, with nearly \$1 trillion owned by individual households.²⁵ Less than 15% of the market, or \$100 billion, was held by the day's mutual funds, pension funds, and insurance companies (respectively holding \$36, \$43, and \$21 billion; or 5%, 6%, and 3%).²⁶

With shareholders so dispersed, prominent corporate theorists had for decades described the challenge of corporate life as the "separation of ownership from control."²⁷ It would be difficult for shareholders to act collectively and often irrational for them to incur the costs necessary to monitor corporate management.²⁸ In this structure, managers held the balance of power over corporate destiny—in American corporate finance, there were

25. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FINANCIAL ACCOUNTS OF THE UNITED STATES: HISTORICAL ANNUAL TABLES 1965–1974 (June 9, 2016).

26. *Id.*

27. See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933) (arguing that the U.S. corporate structure created agency problems).

28. See generally MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION (1965) (explaining the difficulties of collective action).

strong managers yet weak owners.²⁹ Corporate law's principal task, then, was to mitigate the attendant agency costs.³⁰

Post-1965, however, trends moved from individual to institutional ownership and, by the 1990s, those trends had become so powerful that corporate law scholars came to believe that they might mitigate these historical problems.³¹ A promising agenda emerged to enable institutional investors to monitor management more effectively.³² Guidance was provided on what to expect, including realistic cautionary notes, but in general the rise of institutional investors held out great promise for corporate governance.³³

These hopes, however, have been disappointed, as the rise of institutional investors altered but did not resolve the longstanding challenges. Today, institutions command the vast majority of the \$30+ trillion in total market capitalization.³⁴ Among these are mutual funds, pension funds, and insurance companies, together commanding a substantial portion (respectively, \$9.1 trillion, \$2.3 trillion, and \$811 billion).³⁵ They present the old problems of agency costs in new ways due to three critical changes in the institutional investor landscape that have occurred in the past two decades.

Foremost, a large and growing percentage of shares are held by indexers. 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

29. See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994).

30. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

31. See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

32. See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

33. See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991).

34. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *FINANCIAL ACCOUNTS OF THE UNITED STATES: HISTORICAL ANNUAL TABLES 2005-2015* (June 9, 2016); BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *FINANCIAL ACCOUNTS OF THE UNITED STATES: SECOND QUARTER 2018*, at 130 (Sept. 20, 2018).

35. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *FINANCIAL ACCOUNTS OF THE UNITED STATES: SECOND QUARTER 2018*, at 130 (Sept. 20, 2018).

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.

Second is the substantial shortening of average holding periods, indicative of increased trading for arbitrage, momentum strategies, and other short-term drivers. The best-selling financial author Michael Lewis dramatized the stakes in his 2014 book, *Flash Boys*, and the pace of acceleration continues with sustained technological advances in computing algorithms, artificial intelligence, and machine learning.³⁶ Average holding periods shortened significantly from the mid-1960s through the early- or mid-2000s;³⁷ 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.³⁸

Third is the rise of activism. Shareholder gadflies have roamed corporate America since the Gilbert brothers popularized the practice in the 1950s.³⁹ And from the 1970s through the 1990s, incumbent managers faced constant threats to corporate control from rival firms, takeover artists, and colorful raiders such as Carl Icahn and Nelson Peltz.⁴⁰ But it is only in the past two decades that a vast pool of capital developed among specialty firms, dubbed shareholder activists, dedicated to the practice and featuring a

36. See Tom C.W. Lin, *Artificial Intelligence, Finance, and the Law*, 88 FORDHAM L. REV. 531 (2019).

37. Anne M. Tucker, *The Long and the Short: Portfolio Turnover Ratios & Mutual Fund Investment Time Horizons*, 43 J. CORP. L. 581, 587 (2018) (through early 2000s); Edelman et al., *supra* note 4, at 996 (through 2007).

38. K.J. Martijn Cremers & Simone M. Sepe, *Institutional Investors, Corporate Governance, and Firm Value*, 41 SEATTLE U. L. REV. 387, 389 (2018) [hereinafter Cremers & Sepe, *Institutional Investors*].

39. See Lawrence A. Cunningham & Stephanie Cuba, *Annual Shareholder Meetings: From Populist to Virtual*, FIN. HIST., Fall 2018, at 14.

40. See generally KNIGHTS, RAIDERS, AND TARGETS (John C. Coffee, Jr., Louis Lowenstein & Susan Rose-Ackerman eds., 1988) (surveying a variety of research regarding hostile takeovers and the effects takeovers have on acquirers, shareholders, and other players).

well-developed playbook, a cadre of professional advisers, and repeat players such as Bill Ackman, Dan Loeb, and Paul Singer.⁴¹

Facing these forces, it has been easy to overlook the enduring power of the traditional cohort of individual and institutional investors who prefer old-fashioned techniques famously known as buy-and-holds. The style is epitomized by Warren Buffett and Berkshire Hathaway and boasts such notable historical figures as John Maynard Keynes and Benjamin Graham, along with such legacy names as John Neff of Wellington Management or Thomas Rowe Price and his eponymous firm, T. Rowe Price Group Inc.⁴²

B. Classification

Today's diverse shareholder base can be classified in a variety of ways. Which approach is appropriate depends on the purpose of the classification, such as the viewpoint of potential customers, regulators, or researchers.

An obvious formal starting point distinguishes individuals from institutions, which is both straightforward and useful. This delineation is useful for fundamental issues such as the role of government. For example, a government agency might plausibly be charged with developing educational programs for individuals but not institutions and likewise be asked to provide oversight for institutional investors but not individuals.⁴³

A classic formal delineation of institutional investors considers legal forms of organization. Examples include banks, hedge funds, index funds, investment advisers, insurance companies, and mutual funds. Such a scheme is useful for many purposes, such as determining beneficiaries and fiduciary duties, regulatory restrictions, and competitive pressures.⁴⁴

In more functional terms, investment strategy is a way to sort institutional investors, such as technical versus fundamental,

41. See INSTITUTIONAL INVESTOR ACTIVISM: HEDGE FUNDS AND PRIVATE EQUITY, ECONOMICS AND REGULATION 1–35 (William W. Bratton & Joseph A. McCahery eds., 2015) [hereinafter INSTITUTIONAL INVESTOR ACTIVISM].

42. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8, at 13, 15, 104.

43. See Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025 (2009).

44. Bushee, *The “Right” Investors*, *supra* note 9, at 29.

growth versus value, or quantitative versus qualitative.⁴⁵ Those alternatives would be of special interest when investigating relative investment appeal.⁴⁶

Another functional approach would examine trading behavior. For instance, how different shareholders use information may be important when studying market efficiency⁴⁷ or formulating securities regulations.⁴⁸ Helpful categories include insiders, market makers, noise traders, liquidity traders, and information traders.⁴⁹ These groups differ in terms of their access to and use of information, with significant effects on market performance and optimal disclosure laws.⁵⁰

A behavior-based classification of investors might incorporate such varying approaches to handling information. The behavioral division might also consider the central questions in the corporate law debates over time horizons and conviction levels.

In the early 1990s, for example, Harvard Business School professor Porter compared institutional investor behavior in the United States with counterparts in Germany and Japan, whose economies were operating more productively.⁵¹ He reported a U.S.

45. Institutional investors follow a variety of different investment strategies (such as value, growth, or income) or different target sizes (such as small or large cap). Some funds combine these features, classifying as large value, large growth, small value, or small growth. They may rivet on particular sectors or geographic regions or attempt to buy small stakes in essentially every company in the stock market.

46. Some have objectives in addition to traditional shareholder returns, such as promoting the interests of labor. See DAVID WEBBER, *THE RISE OF THE WORKING-CLASS SHAREHOLDER: LABOR'S LAST BEST WEAPON* (2018); Ashwini K. Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting*, 25 REV. FIN. STUD. 187 (2012); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

47. See Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980).

48. See Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 722 (2006).

49. Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 BYU L. REV. 1015, 1029–30 (2014).

50. Insiders have company information, but securities laws limit their right to use it; market makers may have the information, but their trades support balancing supply and demand; noise traders chase fads; liquidity traders act for nonfundamental reasons, such as funding needs or calibrating to an index; and information traders do the heavy lifting of digesting and acting on information. See *id.* at 1030–31.

51. Michael E. Porter, *Capital Choices: Changing the Way America Invests in Industry*, J. APPLIED CORP. FIN., Summer 1992, at 4.

propensity toward either indexing or trading compared to the more concentrated and patient investor model prevalent abroad.⁵²

In the late 1990s, University of Pennsylvania Wharton Business School professor Bushee extended Porter's analysis.⁵³ Bushee noted that Porter's critique overlooked the significant group of U.S. investors who both concentrate and hold — a blind spot that persists in the corporate law literature.⁵⁴ But he stressed that Porter's insight warranted focusing on differences among shareholders represented by two variables: time horizon and conviction.⁵⁵ Bushee identified three categories of institutional investors as follows:

- “transient” institutions, which exhibit high portfolio turnover and own small stakes in portfolio companies;
- “dedicated” institutions, which provide stable ownership and take large positions in individual firms; and
- “quasi-indexers,” which also trade infrequently but own small stakes (similar to an index strategy).⁵⁶

Bushee's empirical work was straightforward. He computed various measures of horizon and conviction: horizon by quarterly portfolio turnover as well as portion held more than two years; and conviction by average percentage ownership of investees, the percentage of investees representing at least a 5% share of the portfolio, and the average size of each investment.⁵⁷ He then combined the horizon and conviction computations to capture the two factors together.

With that ranking, Bushee clustered the results into the three shareholder types and identified exemplars of each. *Transients*, with short time horizons and small stakes, are typified by Numeric, a fund that specializes in exploiting dynamic stock market activity, not fundamental investment analysis of business; *quasi-indexers*, which buy small stakes in 500 to 3000 stocks representing an entire

52. *Id.* at 6–7.

53. Bushee, *The “Right” Investors*, *supra* note 9, at 29–30.

54. *Id.* at 30; *see also infra* Parts II & III.

55. Bushee, *The “Right” Investors*, *supra* note 9, at 29–30 (using the words “stability” and “stakes” rather than “horizon” or “conviction,” respectively, but synonymously).

56. *Id.* Shareholder activists are introduced into this schematic in Section I.C. *See infra* text accompanying note 71.

57. Bushee, *The “Right” Investors*, *supra* note 9, at 30.

market basket, are exemplified by CalPERS, the large California pension fund; and *dedicated shareholders*, those who buy large stakes and hold them for long periods, are epitomized by Warren Buffett's Berkshire Hathaway, he said.⁵⁸

Professor Bushee's work has been widely influential. For example, decades after publication, consulting firm McKinsey & Company offered a similar take.⁵⁹ It called equivalent categories by different names: *intrinsic* instead of *dedicated*, *mechanical* instead of *quasi-indexers*, and *traders* instead of *transients*.⁶⁰ But the analytical utility of the McKinsey and Bushee lexicons is the same and offers a valuable lens for purposes ranging from evaluating investor performance to the expected handling of information and the likelihood of different shareholder cohorts being informed participants in shareholder voting.

In finance scholarship, numerous empirical studies develop tests to identify shareholders who rank high in combined horizon duration and portfolio concentration. For instance, University of Connecticut finance professor Borochin and researcher Jie Yang developed such a database to determine the effects of a company's shareholder base on its governance structure and economic value.⁶¹ Finance professors Cremers of the University of Notre Dame and Pareek of the University of Nevada created a large data set of all institutional investors dating back to 1980, presenting, quarter by quarter, each shareholder's concentration and average holding period.⁶² Cremers and Pareek have been using their data to conduct a variety of tests concerning relative investor performance.⁶³

58. *Id.* at 30–31.

59. Robert N. Palter, Werner Rehm & Jonathan Shih, *Communicating with the Right Investors*, MCKINSEY ON FIN., Summer 2011, at 57, 58–60.

60. *Id.*

61. Paul Borochin & Jie Yang, *The Effects of Institutional Investor Objectives on Firm Valuation and Governance*, 126 J. FIN. ECON. 171 (2017) (including a robust propensity score model for identifying quality shareholders, dubbed "DED" for "dedicated" after Bushee in the model).

62. Martijn Cremers & Ankur Pareek, *Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently*, 122 J. FIN. ECON. 288 (2016) (explaining that the concept of "active share" measures relative concentration of a portfolio compared to a benchmark index, with a pure index active share equal to zero and a completely concentrated portfolio equal to one).

63. The data and related research are posted on the University of Notre Dame website. *Active Share: Academic Research*, U. NOTRE DAME, <https://activeshare.nd.edu/academic-research/> (last visited Sept. 29, 2020).

In legal scholarship, Professor Belinfanti canvassed multiple alternative methods of classifying investors.⁶⁴ Belinfanti features Professor Bushee's method prominently, describing it as a "contemporary" method to "drill down" beyond conventional classifications to focus on important behaviors and propensities.⁶⁵

Similarly, Professors Dallas and Barry use Bushee's classification system in their empirical work on shareholder voting regimes.⁶⁶ For purposes of corporate law, they stress that what matters most is behavior, particularly time horizons and conviction levels.⁶⁷ Dallas and Barry summarize the implications of Bushee's classification scheme for this purpose as follows:

Transient shareholders . . . have the least incentive to "understand drivers of long-run value."

Dedicated investors . . . have the greatest incentive to think about the long term and to take an active role in corporate governance and monitoring of portfolio companies. . . .

Quasi-indexers fall between the other two categories. They . . . have good incentives to think about the company's long-term value, but do not have good incentives to be involved in corporate governance and oversight.⁶⁸

Since Bushee developed his classification system in the late 1990s and early 2000s, the activist shareholder segment developed into a distinctive cohort.⁶⁹ Within Bushee's system, they might be classified as transients if they held for short periods and in low concentrations. But most are highly concentrated in their positions, and sometimes even hold for above-average periods, though their time horizon is routinely portrayed in the literature as short-term.⁷⁰

64. Tamara C. Belinfanti, *Shareholder Cultivation and New Governance*, 38 DEL. J. CORP. L. 789, 818–21 (2014).

65. *Id.* at 820.

66. Dallas & Barry, *supra* note 9, at 625–26 (2016). Part IV of this Article addresses the literature on shareholder voting regimes and normative implications for this Article's analysis.

67. *See id.* at 571. Behavior changes over time. For example, Bushee estimates that about one-fifth of institutional investors change their Bushee classification over a three-year period. *See id.* at n.116 (citing correspondence between Bushee and Dallas).

68. *Id.* at 625–27 (citations omitted).

69. *See* INSTITUTIONAL INVESTOR ACTIVISM, *supra* note 41.

70. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1083 (2007) ("Hedge funds come close to being the archetypal short-term investor."); John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door*:

Given that shareholder activists adopt a unique approach to engagement by public campaigns for corporate change,⁷¹ separately classifying this cohort is analytically useful. The scholarship in the corporate horizon debate provides behavioral profiles of activists, transients, and indexers, to be reviewed in Parts II and III. It has not developed a behavioral profile of the quality shareholder, though this cohort features in other strands of corporate law scholarship. Accordingly, this Part will continue by presenting such a profile.

C. Behavior

Professor Bushee named Buffett's company, Berkshire Hathaway, as exemplifying the "dedicated" or quality shareholder.⁷² Other empirical research identifying quality shareholders invariably places Buffett and Berkshire Hathaway at or near the top.⁷³ Many other corporate law scholars have echoed the point, including Professors Dallas and Barry in their use of the Bushee model in their empirical work.⁷⁴ Professors Choi and Pritchard, in their discussion of the various behaviors that diverse shareholders exhibit, suggest that Buffett is the "paradigm" of such an approach.⁷⁵ Buffett's standing as a model of the patient, committed shareholder has been particularly common among scholars of trust law, where investment theory plays a central role.⁷⁶

Based on my extensive research and writings with and about Buffett over the past three decades, I concur in the conclusion and

The Impact of Hedge Fund Activism on Corporate Governance, 41 J. CORP. L. 545, 573–74 (2016) (observing that hedge funds might be the "archetypal" short-term shareholder but noting that many mutual funds are too).

71. See INSTITUTIONAL INVESTOR ACTIVISM, *supra* note 41.

72. Bushee, *The "Right" Investors*, *supra* note 9, at 31.

73. E.g., Borochin & Yang, *supra* note 61, at 174–75; CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8, at 104.

74. Dallas & Barry, *supra* note 9, at 626.

75. Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 15 n.65 (2003).

76. E.g., Jeffrey A. Cooper, *Empty Promises: Settlor's Intent, the Uniform Trust Code, and the Future of Trust Investment Law*, 88 B.U. L. REV. 1165, 1190–91 (2008) (sharply contrasting Buffett with indexers as well as transients, drawing on prominent detailed accounts of Buffett's philosophy, including my work); see also Stewart E. Sterk, *Rethinking Trust Law Reform: How Prudent is Modern Prudent Investor Doctrine?*, 95 CORNELL L. REV. 851, 873–74 n.121 (2010) (noting my views on Buffett).

can explain the behavior.⁷⁷ First, while Bushee's reference was to Buffett as a shareholder, it is equally true that Buffett as CEO of Berkshire Hathaway consciously cultivated such a cohort among *its* shareholders.⁷⁸ He began doing so two decades before Bushee minted his classification, when Buffett referred to Bushee's cohort of "dedicated" shareholders as "quality" shareholders.⁷⁹ Since "quality" is also an adjective often used by corporate scholars to designate a variety of shareholder behaviors, it is the term this Article will use.⁸⁰

While Buffett is certainly an exemplar, he is part of a long tradition extending back many decades and will leave a legacy of legions of followers in his wake. As for predecessors, consider John Maynard Keynes, the distinguished economist, scholar and investor. Keynes stated his philosophy, based on years of experience and reflection: "I get more and more convinced that the right method in investment is to put fairly large sums" in select enterprises and that it is "a mistake to think that one limits one's risk by spreading too much between [diverse] enterprises."⁸¹ Rather, Keynes avowed: "I believe now that successful investment

77. See BUFFETT, THE ESSAYS, *supra* note 17.

78. See *id.* at 185–88.

79. See Edward B. Rock, *Shareholder Eugenics in the Public Corporation*, 97 CORNELL L. REV. 849, 878–80 (2012) [hereinafter Rock, *Eugenics*] (quoting Letter from Warren E. Buffett, Chairman of the Bd., Berkshire Hathaway to S'holders (Mar. 14, 1984), <http://www.berkshirehathaway.com/letters/1983.html>) (Buffett's description of Berkshire's goal and strategy to attract "high quality shareholders"); BUFFETT, THE ESSAYS, *supra* note 17, at 185–88 ("attracting quality shareholders").

80. E.g., Cynthia A. Williams & John M. Conley, *An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct*, 38 CORNELL INT'L L.J. 493, 519 (2005) (quoting DEP'T OF TRADE & INDUS., DRAFT REGULATIONS ON THE OPERATING AND FINANCIAL REVIEW AND DIRECTORS' REPORT: A CONSULTATIVE DOCUMENT 5–6 (2004)) (U.K. government official favoring "high quality shareholder engagements"); Stephen J. Choi, Jill E. Fisch, Marcel Kahan & Edward B. Rock, *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119, 1164 n.114 (2016) (referring to shareholder proposals as being of "higher- or lower- quality"); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 913 (2013) (referring to the relative quality of shareholder activist proposals). The term should be compared with that of quality investing, referring to an investment strategy seeking to find high-quality businesses that may be purchased at a reasonable price. See *infra* text accompanying note 89.

81. ALLEN C. BENELLO, MICHAEL VAN BIEMA & TOBIAS E. CARLISLE, *CONCENTRATED INVESTING: STRATEGIES OF THE WORLD'S GREATEST CONCENTRATED VALUE INVESTORS* 35 (2016) (citing JOHN F. WASIK, *KEYNES'S WAY TO WEALTH: TIMELESS INVESTMENT LESSONS FROM THE GREAT ECONOMIST* (McGraw Hill 2014)).

depends on . . . a steadfast holding . . . in fairly large units through thick and thin, perhaps for several years”⁸²

Professor Westbrook noted Keynes’ influence on the Berkshire/Buffett style, stressing patience and conviction as defining features.⁸³ On concentration, she notes that diversification is “close to godliness” on Wall Street, but that Buffett holds the opposite conviction.⁸⁴ On the long-term view, Westbrook explains how Buffett consciously cultivated fellow shareholders with such a view because it was so important to his own approach. She explained: “In a world in which investors are told that seconds matter and trading is easy, he advocates buying Berkshire stock and then not touching it again.”⁸⁵

Another Buffett predecessor was Benjamin Graham, his professor at Columbia University and a renowned investor and educator.⁸⁶ Graham taught Buffett—and two generations of followers—the art of value investing.⁸⁷ This involves conducting fundamental analyses of businesses to estimate their value and then buying only the small number that can be obtained at a price substantially below estimated value.⁸⁸ A modern variation on Graham’s technique is called quality investing, or growth investing, which expands the pool to include buying stocks at a

82. *Id.* at 52 (citing David Chambers, Elroy Dimson & Justin Foo, *Keynes the Stock Market Investor: A Quantitative Analysis*, 50 J. FIN. QUANTITATIVE ANALYSIS 843 (2015)). Keynes managed investments for Cambridge University’s King’s College from 1927 to 1945. He concentrated as much as half the portfolio in five companies and held them at least five years apiece. *See id.* at 48, 51. Despite working in a challenging era that included the Great Depression and World War II, returns were impressive: a compound annual growth rate of 9.12% in contrast to the broad U.K. market return of negative 0.89%. *Id.* at 58.

83. Amy Deen Westbrook, *Warren Buffett’s Corporation: Reconnecting Owners and Managers*, 34 OKLA. CITY U. L. REV. 515, 544–45 (2009).

84. *Id.* at 544.

85. *Id.* at 535 (citing Letters from Warren E. Buffet, Chairman of the Bd., Berkshire Hathaway Inc. to S’holders, in WARREN E. BUFFETT, *THE ESSAYS OF WARREN BUFFETT: LESSONS FOR CORPORATE AMERICA* (Lawrence A. Cunningham ed., 2d ed. 2008) at 77–115).

86. *See* BENJAMIN GRAHAM, *THE INTELLIGENT INVESTOR* (1959); BENJAMIN GRAHAM & DAVID DODD, *SECURITY ANALYSIS* (1962).

87. For my analysis of the principles that Graham taught Buffett, see generally LAWRENCE A. CUNNINGHAM, *HOW TO THINK LIKE BENJAMIN GRAHAM AND INVEST LIKE WARREN BUFFETT* (2001); see also Warren Buffett, *The Superinvestors of Graham-and-Doddsville*, HERMES (1985) for a description of how Buffett and other students of Graham practiced the art of investing based on Graham’s teachings.

88. BRUCE N. GREENWALD, JUDD KAHN, PAUL D. SONKIN & MICHAEL VAN BIEMA, *VALUE INVESTING: FROM GRAHAM TO BUFFETT AND BEYOND* (2001).

price that is low in relation to reasonably anticipated growth in intrinsic value.⁸⁹

Professor Lowenstein distilled the Buffett/Graham approach in his corporate law scholarship.⁹⁰ Lowenstein stressed that this approach to investing is based on fundamental business analysis – neither indexing nor trading. The principal criteria are conviction, by holding fewer than twenty stocks, and patience, by holding stocks for an average of at least two years.⁹¹

Quality shareholders adopt a wide variety of diverse strategies for buying, holding or selling, and engaging with management. Buying decisions may be made in accordance with the tenets of Graham's pure value investing, the growth investing extension, or some other variant.⁹² In all cases, however, the investment decision is based upon fundamental business analysis – neither trading activity nor indexing.⁹³ Concentration is invariably the result.⁹⁴

Likewise, quality shareholders may adopt different policies concerning whether and when to sell shares. Although most usually follow Buffett and prefer permanent holding periods,⁹⁵ some may sell when price rises to a significant multiple of value.⁹⁶ Finally, quality shareholders have varying propensities concerning engagement, though their tendency is monitoring at a distance and consulting when asked.⁹⁷ Buffett is again seen to exemplify this

89. See CORNELIUS C. BOND, T. ROWE PRICE: THE MAN, THE COMPANY, AND THE INVESTMENT PHILOSOPHY (2019); LAWRENCE A. CUNNINGHAM, TORKELL T. EIDE & PATRICK HARGREAVES, QUALITY INVESTING (2016); Clifford S. Asness, Andrea Frazzini & Lasse Heje Pedersen, *Quality Minus Junk*, 24 REV. ACCT. STUD. 34 (2019); Robert Novy-Marx, *Quality Investing* (2014) (unpublished manuscript), <https://pdfs.semanticscholar.org/9480/0c35aff62f304d42ac8a9112cd9f40d8e59f.pdf>.

90. Louis Lowenstein, *Searching for Rational Investors in a Perfect Storm*, 30 J. CORP. L. 539, 547 (2005). Professor Lowenstein was a close personal friend of Warren Buffett and long-time investor in Berkshire Hathaway. His son, Roger, a prominent journalist and author, wrote the classic biography, *Warren Buffett: The Making of An American Capitalist*.

91. *Id.* at 547.

92. See JOHN TRAIN, *MONEY MASTERS OF OUR TIME* 306 (2000).

93. ROBERT G. HAGSTROM, *THE WARREN BUFFETT PORTFOLIO: MASTERING THE POWER OF THE FOCUS INVESTMENT STRATEGY* 31 (1999).

94. See ALLEN C. BENELLO, MICHAEL VAN BIEMA & TOBIAS E. CARLISLE, *CONCENTRATED INVESTING* (2017).

95. See BUFFETT, *THE ESSAYS*, *supra* note 17.

96. E.g., JOHN NEFF, *ON INVESTING* 116–17 (1999) (Neff, a quality shareholder, explaining that “You Don’t Have to Buy and Hold Forever”).

97. See ROBERT P. MILES, *WARREN BUFFETT WEALTH: PRINCIPLES AND PRACTICAL METHODS USED BY THE WORLD’S GREATEST INVESTOR* 33–34 (2004).

stance. Professors Bratton and McCahery put it this way: “The model block owner is the legendary Warren Buffett, a fundamental value investor who takes large, under-diversified, long-term positions; monitors carefully; but does not attempt to interfere with the formulation or implementation of the business plan, except in a crisis.”⁹⁸

Manifestations of Buffett’s approach include Berkshire’s large long-term stakes in a relatively small number of companies. Exquisite examples of stakes still held today are nearly 20% of American Express, initially acquired in 1962; nearly 10% of Coca-Cola, initially acquired in 1984; and around 8% of Wells Fargo, initially acquired in 1989.⁹⁹ All of these companies have faced business challenges during Berkshire’s ownership and Buffett has helped behind the scenes, as well as on the board of Coca-Cola for many years, but never interfered publicly.¹⁰⁰

Concerning conviction, quality shareholders view themselves as part owners of a business. Such an ownership sense requires conviction, reflected in thorough research and disciplined decisions. As put by the venerable firm of Ruane Cunniff, founded by another Graham student and Buffett classmate, William Ruane: “We take pride and pleasure in investigating a company from all angles, doing the kind of on-the-ground, primary research that an enterprising journalist might do.”¹⁰¹ Quality shareholders concentrate, often limiting their portfolios to some twenty companies.¹⁰²

98. William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1920 (1995).

99. BERKSHIRE HATHAWAY INC., ANNUAL REPORT (2019).

100. See LAWRENCE A. CUNNINGHAM & STEPHANIE CUBA, MARGIN OF TRUST 78 (2019). In 2014, a shareholder activist launched a public campaign challenging Coca-Cola’s executive compensation plan and urged Berkshire to support it. Instead, Buffett privately engaged outside of the spotlight to resolve the issue. In 2016 concerning American Express, Buffett declined an overture from a shareholder activist seeking change, favoring direct consultation with the long-time chief executive officer.

101. *Philosophy*, RUANE, CUNNIFF & GOLDFARB, <https://www.ruanecunniff.com/Philosophy> (last visited Sept. 4, 2020).

102. For example, Ruane, Cunniff & Goldfarb:

Our small collection of investments bears little resemblance to the S&P 500 or any other index. In fact, our top ten investments often account for >60% of the value of our portfolios. The S&P 500 may be relevant for assessing our performance over the long term, but it has no bearing on how we construct our portfolios.

Id.

Concerning time horizon, quality shareholders are fond of following Buffett in saying their favorite holding period is forever.¹⁰³ They are not motivated to beat the market in any given year but to generate returns over long periods of time. Since quality shareholders are generally risk averse, sustained patience reduces both reinvestment risk and expense risk.¹⁰⁴ Owning outstanding companies for very long periods not only limits risk but reaps the benefits of compounding, a cherished principle of quality shareholders.¹⁰⁵

Quality shareholders reject the prevailing fashion of comparing their annual return with some benchmark index.¹⁰⁶ They eschew reference to the relative volatility of the indexes.¹⁰⁷ Quality shareholders object to the common habit of distinguishing between passive index funds on one hand and all others, dubbed “active,” on the other.¹⁰⁸ They invest for, and measure performance

103. See BUFFETT, *THE ESSAYS*, *supra* note 17.

104. On reinvestment risk, selling shares results in capital needing to be reinvested, and finding new outstanding investments is time consuming and difficult. On expense risk, trading and taxes are immediate costs of selling, disguising the stated nominal returns that draw attention.

105. See Letter from Warren Buffett to Partners of Buffett P’ship, Ltd. (Jan. 18, 1963) (on file with author).

106. *E.g.*, Fundsmith:

Over a sufficient period of time, you will no doubt want to assess our performance against a range of benchmarks—the performance of cash, bonds, equities and other funds, and we will assist you in that process by providing comparisons.

However, we do not think it is helpful to make comparisons with movements in other asset prices or indices over the short term, as we are not trying to provide short term performance.

FUNDSMITH EQUITY FUND, OWNER’S MANUAL 10 (2018).

107. For example, Cedar Rock Capital Partners: “We make no attempt to control volatility relative to any benchmark. We aim to achieve positive returns over the long term, with a strong capital preservation bias.” CEDAR ROCK CAPITAL, <http://www.cedarrockcapital.com> (last visited Aug. 28, 2020).

108. For example, Baillie Gifford:

We are not passive investors who think that current share prices capture the future prospects of companies. We don’t believe that investment decisions can be made on numbers alone, even by super computers and complex algorithms. Passive has its place, providing low-cost market access with, on average, better after fees results than active managers.

However, it has little to do with the process of allocating capital to innovative companies—though on that point it has much in common with many active managers. We are not a typical active manager either: we believe this term has become a one-size-fits-all description which is very unhelpful for investors. It has been hijacked by many fund managers who think it suggests ‘activity’ and simply

over, many years, not annually as is the obsession of many commentators.¹⁰⁹

The philosophy of quality shareholders can be further illuminated by contrasting it with that of indexers. Indexers believe in efficient markets—that share prices reflect future prospects. Quality shareholders doubt that numbers capture all, whether computed by humans, powerful computers, or elaborate algorithms. Quality shareholders conduct the fundamental analysis that is necessary to promote stock market efficiency. In their view, passive funds free ride off of that work.¹¹⁰

The Keynes-Graham-Buffett model continues to attract a large following of quality shareholders. Many are powerful names recognized in the institutional investor world. To illustrate, the following lists several top quality shareholders as identified by Professors Borochin and Yang¹¹¹:

being different from an index. The reality is that much of this activity has more to do with trying to outsmart other investors than with the creative deployment of capital, and that defining active as being different from an index is to start in the wrong place. This is why most active investors fail to deliver returns that outperform passive investment strategies over the long term. They're not even trying to do the fundamental job of investing.

Actual Investors, BAILLIE GIFFORD, <https://www.baillieghifford.com/en/uk/about-us/actual-investors/> (last visited Aug. 28, 2020).

109. Gardner Russo & Gardner:

[Portfolio concentration] may mean temporary depression of market values for companies . . . if and when they are out of favor. However, reduced share prices as a result of market sentiment do not necessarily relate to reduced prospects for our companies' operations. Accordingly, we prefer not to move from sector to sector, following the bubble of the moment. Rather, we prefer to patiently await the market's return to recognition of our businesses' intrinsic value. . . . [T]his may mean that our portfolios undergo periodic under-performance versus the market as a whole.

. . . Because our core positions can be heavily weighted, performance of our portfolios can be dampened by market sentiment, which we regard, however, as immaterial to our investments' long-term potential.

Part 2A of Form ADV: Firm Brochure, GARDNER RUSSO & GARDNER LLC (Mar. 27, 2020), http://files.adviserinfo.sec.gov/IAPD/Content/Common/crd_iapd_Brochure.aspx?BRC_HR_VRSN_ID=630438.

110. See HOWARD MARKS, *INVESTING WITHOUT PEOPLE* (2018).

111. Borochin & Yang, *supra* note 61, at 175.

Top Quality
Berkshire Hathaway Capital Research & Management Fidelity Management & Research Harris Associates (Oakmark Funds) State Farm Insurance Southeastern Asset Management Wellington Management

Like Berkshire, these quality shareholders have large parts of their portfolios invested in sizable stakes of major companies held for many years. Examples include Capital Research in Abbott Labs; Fidelity in Salesforce; Harris in Tenet Health; State Farm in Air Products; Southeastern in Graham Holdings; and Wellington in Marsh & McLennan and PNC Financial.¹¹² Other examples of such quality shareholders and stakes are the positions of Franklin Resources in Roper and Massachusetts Financial in Accenture.¹¹³

In short, quality shareholders embrace a philosophy of investing characterized by patience and focus. Despite their passion for this approach, however, quality shareholders face relentless competitive pressures.

D. Competition and Performance

Today's institutional investors face pressure to favor indexing or transience. Compensation of fund managers is often based on annual returns, so the question becomes whether an investor beat the market for a given year or not. In such an environment, pressure is substantial to diversify widely on the one hand and, on the other, to chase returns by rapid trading. While quality shareholders reject and resist such approaches, the result is a rising portion of indexers and transients compared to quality shareholders.

The effects of this intensive environment are reflected in estimates of the relative size of these cohorts. The number of different indexes has proliferated—at least sixty major ones by one count, with Morningstar alone designating at least 300 different

112. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8.

113. *Id.*

indexes.¹¹⁴ Self-described index funds easily manage at least 20% of total market capitalization, a figure that rises to as much as 40% if counting funds that hug indexes without describing themselves as index funds.¹¹⁵

Transient holders are numerous, reflected in high share turnover. In the past two decades, average holding periods for hedge funds have fallen to under one year and for mutual funds under two.¹¹⁶ In recent years, overall average time horizons have remained unchanged, though this is likely due to the rise of indexers, which trade infrequently, offset by the rise in transients, which trade often.¹¹⁷ Together, this transient cohort represents perhaps as much as 40% of total market capitalization as well.¹¹⁸

At the other extreme, activists in aggregate command relatively small stakes, not likely more than 5% of all, though they strategically leverage their power during campaigns. Quality shareholders make up the rest.¹¹⁹ While small overall—perhaps 15% of all equity—this cohort can be mobilized for amplified

114. Families of benchmarks propagate multiple indexes, now numbering as many as sixty. These include Dow Jones (at least six: DJ Industrial Average, DJ US Select Dividend, DJ Wilshire 4500, and DJ Wilshire 5000); FTSE (four: FTSE High Dividend Yield, FTSE RAFI US 100, and Mid Small 1500); NASDAQ (two: NASDAQ 100 and the NASDAQ Composite); and Schwab (two, including the Schwab 1000 and Schwab Small Cap). Dozens more are offered by several behemoths delineating among small, mid, and large cap plus their value and growth components: MSCI (fifteen different ones), S&P (fourteen) and Russell (thirteen).

115. Recently, total market cap of the Russell 3000 was about \$30 trillion. Of that, operators of the largest passive indexers commanded nearly half, at around \$14 trillion (though some run stock-picking funds too). Pension funds as a group held about one-third or \$9 trillion, much prone to quasi-indexing, though some to dedication. Activist hedge funds own a sliver—around \$100 billion or 1%—though they back that capital with powerful game-changing strategies for companies. Given the high level of aggregate share turnover—average holding periods barely near one year—many on the typical shareholder list do not stay a long time, making for a sizable portion of transients. More specifically, five of the largest activist hedge funds command in aggregate perhaps \$100 billion (Ichan, Third Point, ValueAct, Pershing, Trian) whereas the largest four financial institutions manage \$14 trillion (BlackRock, State Street, Vanguard, and Fidelity). Among pension funds, the five largest together run nearly \$1 trillion (CalPERS, CALSTRs, STRS Ohio). The quality investing cohort represents the rest. Yet the power of even such relatively small stakes is immense. For perspective, the largest listed companies now boast market caps around \$1 trillion and many smaller ones around \$4 to \$10 billion.

116. See sources cited *supra* note 37.

117. See *supra* text accompanying note 38.

118. See *supra* note 115.

119. See *supra* note 115.

influence, sometimes playing important roles in corporate power struggles.¹²⁰

What leads a particular investor, or institution, to adopt one investment strategy or another is partly a function of personality and partly of expected returns.¹²¹ For nearly two decades, debate has raged around whether stock indexing or stock picking is a superior strategy, often delineating further into types of broad indexes (by size, sector, or geography) with stock pickers competing against that benchmark.¹²² Debate dates to a 1997 article by Mark Carhart, then a professor of finance at the University of Southern California, finding no evidence of successful mutual fund stock pickers.¹²³

Ensuing research contributed to what became conventional wisdom, such as: average active funds underperform the market after fees;¹²⁴ top fund performance doesn't persist;¹²⁵ and, while some managers are skilled, few deliver on that value for customers after fees.¹²⁶ Yet debate continues, and Buffett won a famous bet siding with indexers over hedge funds—at least those hedge funds that charge particularly high fees.¹²⁷ Multiple editions of

120. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8, at 19–27 (giving examples of quality shareholders' roles in activist campaigns concerning Pernod Ricard, Ashland Global Holdings, and United Technologies).

121. See Henrik Cronqvist, Stephan Siegel & Frank Yu, *Value Versus Growth Investing: Why Do Different Investors Have Different Styles?*, 117 J. FIN. ECON. 333 (2015).

122. See Martijn Cremers, Jon Fulkerson & Timothy B. Riley, *Challenging the Conventional Wisdom on Active Management: A Review of the Past 20 Years of Academic Literature on Actively Managed Mutual Funds*, 75 FIN. ANALYSTS J. 8 (2019).

123. Mark Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57 (1997) (finding that the empirical evidence did “not support the existence of skilled or informed mutual fund portfolio managers”). Michael Jensen conducted an earlier kindred study. Michael Jensen, *The Performance of Mutual Funds in the Period 1945–1964*, 23 J. FIN. 389 (1968).

124. William Sharpe, *The Arithmetic of Active Management*, 47 FIN. ANALYSTS J. 7 (1991).

125. Mark Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57 (1997).

126. Eugene Fama & Kenneth French, *Luck Versus Skill in the Cross-Section of Mutual Fund Returns*, 65 J. FIN. 1915 (2010).

127. In 2008, Buffett bet a hedge fund manager the S&P 500 would, over the ensuing ten years, outperform, after fees, any hedge fund portfolio the manager cared to assemble. See BUFFETT, THE ESSAYS, *supra* note 17, at 180–83. The manager assembled a fund of funds, a configuration charging multiple layers of high fees. During the first three years, the S&P lagged the fund, but by bet's end, the S&P won. If many took from the bet the lesson that indexers are always superior to non-indexed investing, that is a mistake. The primary point was to stress that ordinary individuals are almost certainly better off, given the risks and fees, of staking their savings in index funds rather than entrusting it to high-cost hedge funds.

best-selling books continue to showcase dueling university professors: University of Pennsylvania finance professor Siegel has repeatedly shown that buy-and-hold works,¹²⁸ while Princeton University finance professor Malkiel continues to release new editions of the book that legitimized indexing as a strategy.¹²⁹

Changes in shareholder demographics during the past two decades, including increased competition and lower fees, have produced a new strand of research challenging these conventional views. For instance, there is evidence that the average active fund does outperform an equivalent index;¹³⁰ some top-performance records do persist;¹³¹ and a sizable cohort of managers with particular traits demonstrate skill that covers their fees.¹³² Among those traits are conviction and patience—the defining traits of quality shareholders.

E. Advantages

So far, this Article has discussed the fragmentation, classification, behavior, and performance of different shareholders.

Each shareholder segment adds unique value: activists promote management accountability; index funds enable millions to enjoy market returns at low cost; and traders offer liquidity.

With such advantages, however, come disadvantages: activists become overzealous; indexers lack resources to understand specific company details; and traders induce a short-term focus. Quality shareholders balance the base and counteract these downsides.

As to curbing overzealous activism, quality shareholders can be white squires—a term dating to the 1980s referring to block

128. See JEREMY J. SIEGEL, *STOCKS FOR THE LONG RUN* (5th ed. 2014); see also LOUIS ENGEL & HENRY R. HECHT, *HOW TO BUY STOCKS* (8th ed. 1994).

129. See BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* (12th ed. 2019).

130. Jonathan B. Berk & Jules H. van Binsbergen, *Measuring Skill in the Mutual Fund Industry*, 118 J. FIN. ECON. (2015); Jonathan B. Berk & Jules H. van Binsbergen, *Mutual Funds in Equilibrium*, 9 ANN. REV. FIN. ECON. 147 (2017); Hyunglae Jeon, Jangkoo Kang & Changjun Lee, *Precision About Manager Skill, Mutual Fund Flows, and Performance Persistence*, 40 N. AM. J. ECON. FIN. 222 (2017).

131. Nicolas Bollen & Jeffrey Busse, *Short-term Persistence in Mutual Fund Performance*, 18 REV. FIN. STUD. 569 (2004); Robert Kowoski, Allan Timmermann, Russ Wermers & Hal White, *Can Mutual Fund “Stars” Really Pick Stocks? New Evidence from a Bootstrap Analysis*, 61 J. FIN. 2551 (2006).

132. Yakov Amihud & Ruslan Goyenko, *Mutual Fund’s R2 as Predictor of Performance*, 26 REV. FIN. STUD. 667 (2013); Martijn Cremers & Antti Petajisto, *How Active is Your Fund Manager? A New Measure that Predicts Performance*, 22 REV. FIN. STUD. 3329 (2009).

shareholders tending to support management.¹³³ When a board perceives activist excess, it helps to have a few large long-term owners to consult. As a united front, the company's hand is strengthened, resisting excess while addressing legitimate concerns activists may have.¹³⁴

Quality shareholders study company specifics which indexers, being stretched thin, cannot.¹³⁵ Indexers may be good at analyzing dynamic issues as they arise, but rarely develop deep knowledge that quality shareholders command. Indexers invest most of their limited resources to develop views about what is best generally in corporate governance, not what is best for particular companies.

Quality shareholders differ from both activists and indexers regarding director elections. While activists often nominate directors fellow board members resist, and indexers almost never nominate directors at all, quality shareholders offer a supply of outstanding directors for their investees, often themselves.¹³⁶

Because of their long-term investments, quality shareholders offset the short-term preferences of transients. A high density of quality shareholders, with their characteristic patience, helps managers operate strategically, with a long-term outlook.¹³⁷ Such effects can percolate throughout a company. If less pressure comes from shareholders to produce short-term results, then directors, officers, employees, suppliers, strategic partners, and others can operate in the same manner.¹³⁸

133. See *supra* note 120.

134. See James Woolery, Rob Leclerc & Richard Fields, *The Ashland-Cruiser Proxy Contest – A Case Study*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 20, 2019), <https://corpgov.law.harvard.edu/2019/02/20/the-ashland-cruiser-proxy-contest-a-case-study/>.

135. See *infra* Part III for an extended discussion of the related debate.

136. See *infra* text accompanying notes 267–78; CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8 at 28–34 (examples from AutoNation, Berkshire Hathaway, Constellation Software, Credit Acceptance Corporation, Enstar, Fairfax Financial, Teledyne, The Washington Post Company).

137. See 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. MGMT. J. 723 (2010) (adapting Bushee's empirical method and classification finding positive association between high density of quality shareholders and strategic management decision making).

138. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8 at 28–34 (citing Leucadia Corporation and Markel Corporation).

Shareholder cohorts have different preferences about the price levels of stocks they own. To illustrate briefly:

- transients generally prefer the highest price possible for maximum profit on immediate sale;
- indexers favor the highest reasonable price because they assume, consistent with efficient market theory, that price and value are substantially the same; and
- quality shareholders, who are generally uninterested in an immediate sale and attuned to stock market volatility, prefer a stock price that bears the most rational relationship possible to the company's intrinsic business value.¹³⁹

Many managers tend to likewise prefer the highest possible stock price, perceiving it as a measure of their own performance—the higher the better.¹⁴⁰ But while they often complain that their company's stock price is too low, under- and over-pricing are equally likely and neither is desirable.¹⁴¹

A share price that is rationally related to business value can be a huge asset for several purposes, including making acquisitions, compensating employees, and facilitating fairly priced gains (or losses) when shareholders must sell.¹⁴² While there is a lively debate over the degree of such market efficiency—of how well price approximates value—companies with the closest nexus enjoy clear advantages over those with the widest gaps. Evidence suggests that companies with ownership dominated by quality shareholders tend to enjoy stock prices that are less volatile and more rationally related to business value.¹⁴³

139. See BUFFETT, THE ESSAYS, *supra* note 17, at 38 (explaining the virtues of a rational stock price as opposed to an elevated stock price). At purchase, of course, quality shareholders seek prices below value.

140. See BARUCH LEV, WINNING INVESTORS OVER: SURPRISING TRUTHS ABOUT HONESTY, EARNINGS GUIDANCE, AND OTHER WAYS TO BOOST YOUR STOCK PRICE 103–05 (2012) (suggesting that managers care more about underpricing than overpricing).

141. *Id.* at 105.

142. See BUFFETT, THE ESSAYS, *supra* note 17, at 38 (Berkshire's owner-related business principles, number 14).

143. See BOROCHIN & YANG, *supra* note 61. Other recent research affirms other advantages that long-term investors contribute to companies they invest in. Jarrad Harford, Ambrus Kecskés & Sattar Mansi, *Do Long-Term Investors Improve Corporate Decision Making?* (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2505261. Longstanding empirical research has generally found that inclusion in an index drives stock price up. See Prem C. Jain, *The Effect on Stock Price of Inclusion in or Exclusion from the S&P 500*, 43 FIN.

With such advantages on offer, amid today's fragmented shareholder base, the quality shareholder cohort remains a valuable force in the investment community and stock markets.

II. TIME HORIZON

For decades, corporate law professors have debated shareholder time horizons. Critics focus on the short-termism of the shareholder activist. Defenders dispute the claim that short-termism is a problem at all, let alone one exemplified by activists.

Amid the academic debate, considerable policy changes occurred in the broader process of legal and business evolution. These policy dynamics were so diverse—expanding shareholder power in some areas while curtailing it in others—that both sides of the academic debate could cite accomplishments but would also have to acknowledge setbacks.¹⁴⁴

At present, therefore, the academic debate is at something of a stalemate. This Part reviews the academic theory and debate, along with the major policy implications, illustrating important effects of adding quality shareholders on topics such as staggered boards and splitting versus combining the roles of board chairman and CEO.

A. Theory and Debate

In traditional economic theory concerning stock market prices and managerial behavior, short-termism cannot exist.¹⁴⁵ For one, competitive processes optimize any trade-off between short- and

ANALYSTS J. 58, 58–60 (1987). Early evidence showed the increase ranged from 3% to 9%. Antti Petajisto, *The Index Premium and Its Hidden Cost for Index Funds*, 18 J. EMPIRICAL FIN. 271, 272 (2011); Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579, 584 (1986); William B. Elliott, Bonnie F. Van Ness, Mark D. Walker & Richard S. Warr, *What Drives the S&P 500 Inclusion Effect? An Analytical Survey*, 35 FIN. MGMT. 31, 31 (2006). This occurs as a result of supply and demand, as indexers buy the stock automatically. This drives price above value. Moreover, much of the evidence indicated that this price effect was not temporary. Although the effects may diminish over time and on more prominent indexes, permanent market distortions remain a factor. See Scott Hirst & Kobi Kastiel, *Corporate Governance and Index Exclusion*, 99 B.U. L. REV. 1229 (2018).

144. See *infra* text accompanying notes 170–72.

145. See, e.g., Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 1004 (2013).

long-term values.¹⁴⁶ In addition, efficient stock markets rapidly impound into price all relevant long-run information.¹⁴⁷ At a minimum, current stock price is the best estimate of long-term corporate value.¹⁴⁸ Strategies that will deliver value tomorrow are manifest in stock price today.

A rival stance in economic theory contends that short-termism can arise from two sources: market myopia or managerial myopia. Market myopia occurs when investors fail to price shares correctly due to informational asymmetry between managers and investors. For example, managers may fear short-term market punishment for failure to meet quarterly earnings expectations, and therefore might forego costly research and development (“R&D”) in order to maintain current share price.¹⁴⁹

Managerial myopia occurs when managers take opportunistic advantage of information asymmetries favoring them. A manager’s decision may yield rewards that are optimal for them—without regard to time horizon—though impair long-term shareholder value. Examples are permanent boosts to a manager’s reputation or immediate bonuses from executing projects with inferior long-term corporate payoffs.¹⁵⁰

The law and economics literature on short-termism adds another source: impatience. Some shareholders have immediate liquidity needs prompting them to sell.¹⁵¹ The effect is to rivet on prevailing price rather than longer-term value. Again, under efficient market theory, this cannot occur, but under this rival

146. See Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, 4 MIDLAND CORP. FIN. J. 1, 5–6 (1986).

147. See Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992).

148. See Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1660–62 (2013) [hereinafter Bebchuk, *The Myth*].

149. See, e.g., Kenneth A. Froot, David S. Scharfstein & Jeremy C. Stein, *Herd on the Street: Informational Inefficiencies in a Market with Short-Term Speculation*, 47 J. FIN. 1461, 1480–81 (1992); Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have*, 13 J. FIN. ECON. 187, 212–13 (1984). See generally Michael J. Brennan, *Latent Assets*, 45 J. FIN. 709 (1990) (distinguishing “latent assets” whose values are not reflected in share prices).

150. See, e.g., Bengt Holmstrom & Joan Ricart i Costa, *Managerial Incentives and Capital Management*, 101 Q. J. ECON. 835 (1986); Tim S. Campbell & Anthony M. Marino, *Myopic Investment Decisions and Competitive Labor Markets*, 35 INT’L ECON. REV. 855 (1994).

151. See John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991).

theory such behavior can pressure managers to pursue short-term profits at the expense of long-term investment.¹⁵²

Since such liquidity effects arise only for impatient investors, legal scholars wondered whether there are too many of them and what, if anything, corporate law might do about that. Critics targeted shareholder activists, especially hedge funds specializing in that approach. Opponents, while acknowledging some costs, stressed the gains in accountability and long-run prosperity.¹⁵³ Shareholders are the best incentivized participants to assure managerial accountability, after all.¹⁵⁴ Many are even better informed than corporate boards and therefore likely to be effective in overseeing wayward managers.¹⁵⁵ They develop expertise in governance and strategy to provide superior solutions.

In the ensuing corporate law scholarship debate, contestants dispute the extent of the empirical evidence on short-termism. Prominent among the empirical researchers is the work of Professor Bushee—although not so much embracing his entire classification scheme as focusing on his related research on the effects of a high density of transients in a shareholder base.¹⁵⁶

In an often-cited work,¹⁵⁷ Bushee found that “transient ownership creates incentives for managers to sacrifice long-term investment to avoid a decline in current earnings.”¹⁵⁸ He profiled all companies positioned to reverse a year-on-year earnings decline

152. See Choi & Pritchard, *supra* note 75; Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767 (2002).

153. Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1089 (2015); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

154. See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983). FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 73 (1991).

155. Gilson & Gordon, *supra* note 80, at 897.

156. See Brian Bushee, *Do Institutional Investors Prefer Near-Term Earnings Over Long Run Value?*, 18 CONTEMP. ACCT. RSCH. 207, 213 (2001) [hereinafter Bushee, *Near-Term*]; Brian J. Bushee & Christopher F. Noe, *Corporate Disclosure Practices, Institutional Investors, and Stock Return Volatility*, 38 J. ACCT. RSCH. 171 (2000).

157. Bushee, *Myopic R&D*, *supra* note 11, at 330 (this article is cited some 4,000 times according to Google Scholar (last visited January 15, 2020)); see also Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 581 (2016) (citing Brian J. Bushee, *The Influence of Institutional Investors on Myopic Investment Behavior*, 73 ACCT. REV. 305 (1998)); David Millon, *Shareholder Social Responsibility*, 36 SEATTLE U. L. REV. 911, 913–14 (2013).

158. Bushee, *The “Right” Investors*, *supra* note 9, at 31.

by reducing R&D spending. Companies with a high density of transients were significantly more likely to do so than those with lower transient populations.

Professors Coffee and Palia attest to the significance of Professor Bushee's work and the long line of research that has followed and affirmed it. In their 2016 article on activism, for example, they introduce the line of scholarship to "strongly suggest" that shareholder base influences corporate time horizons.¹⁵⁹ The authors note that Bushee's research dates to 1998, and highlight two major articles, finding that companies with high transient density are (1) more prone to earnings management such as R&D spending cuts and (2) more likely to be valued based on near-term earnings rather than long-term earnings.¹⁶⁰ They reference further studies affirming the findings and adding that high transient density weakens shareholder oversight of managers and adds pressure for near-term earnings over long-term value.¹⁶¹

Other participants in the horizon debate start by citing Bushee's work as evidence of short-termism, before moving on to argue broader normative implications. For instance, Professor Dallas challenges the shareholder value maximization norm because, per Bushee, short-term shareholders pressure managers for short term results with related evidence of earnings management.¹⁶² For another, Professor Millon, who elaborates on Bushee's shareholder classification scheme more fully, finds compelling evidence

159. John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 573–74 (2016).

160. *Id.* at 574 nn.109 & 111 (citing, respectively, Bushee, *Myopic R&D*, *supra* note 11, at 330; Bushee, *Near-Term*, *supra* note 156, at 213).

161. Coffee & Palia, *supra* note 159, at 574 nn.111–13 (citing numerous articles, including Kevin J. Laverty, *Economic "Short-Termism": The Debate, the Unresolved Issues, and the Implications for Management Practice and Research*, 21 ACAD. MGMT. REV. 825 (1996); Xia Chen, Jarrad Harford & Kai Li, *Monitoring: Which Institutions Matter?*, 86 J. FIN. ECON. 279 (2007); Jose-Miguel Gaspar, Massimo Massa & Pedro Matos, *Shareholder Investment Horizons and the Market for Corporate Control*, 76 J. FIN. ECON. 135 (2005); François Derrien, Ambrus Kecskés & David Thesmar, *Investor Horizons and Corporate Policies*, 48 J. FIN. & QUANTITATIVE ANALYSIS 1755 (2013); Katherine Guthrie & Jan Sokolowsky, *Large Shareholders and the Pressure to Manage Earnings*, 16 J. CORP. FIN. 302 (2010)).

162. Lynne L. Dallas, *Is There Hope for Change: The Evolution of Conceptions of "Good" Corporate Governance*, 54 SAN DIEGO L. REV. 491, 538 (2017) (citing Bushee, *Myopic R&D*, *supra* note 11, at 307); Bratton & Wachter, *supra* note 2, at 702–03.

of short-termism to demand that corporations take greater social responsibility.¹⁶³

On the other side of the debate, many corporate law scholars find evidence of short-termism too limited to warrant substantial legal or policy changes. Professor Fried, for one, says “only a few” studies have found significant short-termism.¹⁶⁴ Professors Bebchuk, Dent, and Roe all separately arrived at similar conclusions.¹⁶⁵ Despite that point, Fried says there is no question that short-term shareholder interests “are not perfectly aligned with [profit] maximization.”¹⁶⁶

If the empirical evidence is mixed,¹⁶⁷ so are the realities: even if some activists have short-term bias, they need support of a large bloc of other shareholders to influence corporate policy.¹⁶⁸ Importantly, that group would be comprised of a diverse group of shareholders, including transients, indexers, and quality shareholders. Yet the literature in this debate tends to group all such others under the broad umbrella of “institutional investors.”¹⁶⁹

Amid such disagreement on the facts as to short-termism, corporate law scholars have joined debate over the legal stakes. All participants agree that these are vast. At the most general level, they pose the hoary corporate law question of allocation of power between directors and officers on the one hand and shareholders

163. David Millon, *Shareholder Social Responsibility*, 36 SEATTLE U. L. REV. 911, 914 (2013) (“[T]here is broad agreement that short-termism is widespread in the current investment landscape.”).

164. Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1582 (2015) (citing Bushee, *Myopic R&D*, *supra* note 11 and Natasha Burns, Simi Kedia & Marc Lipson, *Institutional Ownership and Monitoring: Evidence from Financial Misreporting*, 16 J. CORP. FIN. 443, 444 (2010) (finding association between transient density and probability and severity of restated financial reports)).

165. Bebchuk, *The Myth*, *supra* note 148, at 1643–44 (little evidence that short-term holder influence undermines long-term value creation); George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 149–50 (2010) (very little evidence of short-termism); Roe, *supra* note 145, at 1004 (insufficient evidence to warrant changes in corporate law).

166. Fried, *supra* note 164, at 1583.

167. See also Tucker, *supra* note 37; Cremers & Sepe, *Institutional Investors*, *supra* note 38; *supra* text accompanying notes 37–38.

168. See Luca Enriques, Ronald J. Gilson & Alessio M. Paces, *The Case for An Unbiased Takeover Law*, 4 HARV. BUS. L. REV. 85, 96 n.36 (2014).

169. E.g., *id.*

on the other.¹⁷⁰ Those who see short-termism as a serious problem look to weaken shareholder power and strengthen managerial power; opponents, viewing short-termism as at best an annoyance, worry about insulating managers from accountability.¹⁷¹

In play are all aspects of corporate governance, from proxy access and poison pills to voting rules. During the course of the horizon debate, proponents of shareholder empowerment won many victories, but so too did their opponents.¹⁷² Still up in the air are a variety of debated governance devices, such as staggered boards, chairman/CEO roles, and shareholder voting – all of which are considered later in this Article. These unresolved debates reflect how, to a significant degree, the horizon debate has reached a stalemate, as the next Section shows. Adding quality shareholders to the discussion could help unlock them, as the ensuing Section illustrates.

B. Status and Direction

For a snapshot of the current state of the horizon debate, consider the content of a major 2018 symposium on the subject, which Professor Tucker hosted.¹⁷³ It featured a dozen rich and original pieces, all making fascinating contributions and drawing attention to the relative virtues and differences in time horizon.

Indeed, a few delineated time horizon more finely or sought to rephrase the horizon issue as whether a given time horizon accords with related risk assumed.¹⁷⁴ Some prescribed sweeping systemic steps to counteract short-termism for social benefit through such

170. See Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987 (2010).

171. See sources cited *supra* note 2.

172. See Cremers & Sepe, *Institutional Investors*, *supra* note 38, at 397 n.37 (delineating a variety of pro-shareholder victories arising from this debate, including: shareholder activism, emergence of proxy advisory firms, majority voting and withhold campaigns, growing use and success of shareholder proposals, amendments to proxy filing requirements facilitating use of shareholder proposals, amendments to the Delaware corporate law statute favoring proxy access, say-on-pay shareholder votes, and expansion of the scope of shareholder proposals to effect changes in corporate election procedures).

173. See Anne Tucker, *20/20 Vision in the Long & Short-Termism Debate*, 41 SEATTLE U. L. REV. 337 (2018) [hereinafter Tucker, *20/20 Vision*].

174. E.g., Jim Hawley & Jon Lukomnik, *The Long and Short of It: Are We Asking the Right Questions: Modern Portfolio Theory and Time Horizons*, 41 SEATTLE U. L. REV. 449, 449 (2018); Frank Partnoy, *Specificity and Time Horizons*, 41 SEATTLE U. L. REV. 525 (2018); Andrew Verstein, *Wrong-Termism, Right-Termism, and the Liability Structure of Investor Time Horizons*, 41 SEATTLE U. L. REV. 577 (2018).

innovations as federal savings accounts or universal equity funds¹⁷⁵ or at the very least designing executive pay to reward long-term performance.¹⁷⁶

In a more skeptical contribution to the symposium, Professor de Fontenay detected a tendency of debaters to imagine an ideal shareholder to measure others against.¹⁷⁷ In the literature, the ideal is vaguely reported as a “long-term” and “active monitor” but without much detail, de Fontenay said, and for good reason, she adds: there is no such ideal.¹⁷⁸ Rather, given both the diversity of shareholders and the dynamic rate of change in capital markets, lawyerly interventions to promote or retard particular shareholder types are doomed, she argued.¹⁷⁹

De Fontenay may be right, and the evidence in the horizon debate is mixed enough to warrant caution. But the literature’s nearly exclusive emphasis on horizon obscures the element of relative concentration, whose inclusion might alter the case about whether there is such an ideal. At minimum, further delineation of shareholder types based on conviction would help move the debate forward.

Two empirical pieces in the symposium made such headway towards a more complete picture. In one, Professors Sampson and Shi drew upon Bushee’s classification, finding evidence that transients have a greater presence and quality shareholders (dedicated) a lesser presence over the period from 1980 to 2013.¹⁸⁰ These observations took into account both time and conviction. While valuably delineating shareholder types, these scholars examined the implications for national economic performance rather than for corporate governance.

In their contribution to the symposium, Professors Cremers and Sepe explicitly added relative shareholder concentration to relative time horizons. They explained that accounts in the legal literature

175. William A. Birdthistle, *Federalism of Personal Finance: State and Federal Retirement Plans*, 41 SEATTLE U. L. REV. 367 (2018); Lynn Stout & Sergio Gramitto, *Corporate Governance as Privately-Ordered Public Policy: A Proposal*, 41 SEATTLE U. L. REV. 551 (2018).

176. Caroline Flammer, *Long-Term Executive Compensation as a Remedy for Corporate Short-Termism*, 41 SEATTLE U. L. REV. 419, 420 (2018).

177. See generally de Fontenay, *supra* note 12.

178. *Id.*

179. *Id.*

180. Rachelle Sampson & Yuan Shi, *Are Investor Time Horizons Shortening?*, 41 SEATTLE U. L. REV. 543 (2018).

tend to present investors in “dichotomic” terms, as always short-term or always long-term, while the truth is more complex, requiring “a more exact taxonomy of institutional investor behavior along the two crucial dimensions of institutional investors’ investment horizons and activism.”¹⁸¹ They concluded by mediating the horizon debate’s “polarized rendering” in favor of capturing “nuances that depend on a variety of factors” that the “law and economics literature has paid relatively little attention to.”¹⁸²

This is a promising advance, although subtle and limited. It is so subtle, for instance, that the innovation was not among those highlighted in the editor’s overview of the symposium.¹⁸³ It is limited in that the study used conviction (“active share”) as a proxy for activism.¹⁸⁴ Active share is usually about investment concentration, however, not inclination or style of engagement.¹⁸⁵ It can be a partial proxy for activism, but concentration is a defining trait of quality (dedicated) shareholders. A next step in the research would tease out, within the data, those shareholders with high concentrations as well as long holding periods. That would be the quality shareholder cohort.¹⁸⁶ A few of the many implications of doing so are reviewed next.¹⁸⁷

181. Cremers & Sepe, *Institutional Investors*, *supra* note 38, at 389.

182. *Id.* at 392, 398–99.

183. Tucker, *20/20 Vision*, *supra* note 173, at 337.

184. Cremers & Sepe, *Institutional Investors*, *supra* note 38, at 405.

185. *See supra* text accompanying notes 57–62.

186. I confirmed my interpretation via email with Professor Sepe (Jan. 20, 2020).

187. *Boston University Law Review* published a symposium in 2019 with twenty-two articles—spanning some 600 pages—under the heading “Institutional Investor Activism.” Important and broad ranging, several pieces focused on aspects of the horizon debate as well as the conviction debate. None, however, discussed combining the two behaviors.

On horizon debate: Marcel Kahan & Edward Rock, *Anti-Activist Poison Pills*, 99 B.U. L. REV. 915 (2019); Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971 (2019).

On conviction debate: Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721 (2019); Scott Hirst & Kobi Kastiel, *Corporate Governance by Index Exclusion*, 99 B.U. L. REV. 1229 (2019).

On voting: David H. Webber, *Reforming Pensions While Retaining Shareholder Voice*, 99 B.U. L. REV. 1001 (2019); Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151 (2019).

C. Policy Implications

Adding discussion of quality shareholders to the horizon debate would enable distinguishing not merely short- versus long-term but long-term with or without concentration. To illustrate how the addition would illuminate specific corporate law debates, consider two controversial governance features: staggered boards, and splitting versus combining the roles of board chairman and CEO.

First, a long-standing sub-debate in corporate law considers the superiority of unitary versus staggered boards. With unitary boards, all seats are filled in annual elections; with staggered boards, each director serves a term of two or three years.¹⁸⁸ Proponents of staggered boards stress advantages such as continuity and institutional knowledge while critics cite insulation from accountability.

Corporate law scholars, as well as major indexers, challenge staggered boards as excessively pro-management. Professor Bebchuk has been an outspoken opponent of staggered boards.¹⁸⁹ Students at his law school mounted national campaigns to de-stagger boardrooms across corporate America.¹⁹⁰ He and his colleagues marshalled impressive research data to contend that staggered boards reduced firm value.

In the other corner of this contentious debate stood Professor Cremers and his colleagues, who put forth equally intense counterarguments and opposing data sets showing that staggered boards increased firm value. This camp of scholars, which included some judges and prominent lawyers,¹⁹¹ argued for staggered boards as either a default rule or as a requirement.¹⁹²

188. E.g., DEL. CODE ANN. tit. 8, § 141(d) (2020).

189. E.g., Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005).

190. See *Course Catalogue: Shareholder Rights Project*, HARV. L. SCH., <https://hls.harvard.edu/academics/curriculum/catalog/index.html?o=64841>.

191. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *The Great Takeover Debate: A Mediation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1097 (2002) (judges proposing three-year terms); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 225–30 (1991) (prominent corporate lawyers proposing five-year terms).

192. See generally K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67, 77–81 (2016) (exploring the benefits of staggered boards).

Recent scholarship challenges the reliability of both empirical sides of the argument, contending instead that neither is right: whether a staggered board is good or bad depends on the company.¹⁹³ The attempt to settle this debate is another way of recasting the horizon debate in more holistic terms. In some of the empirical work—and in much of the rhetoric, described as “polemical”¹⁹⁴—the board structure sub-debate was a microcosm of the horizon debate: proponents of staggered boards urged long-term value against short-term interests while opponents of staggered boards denied that they had a short-term focus.

In attempting to settle the debate, Amihud, Schmid, and Solomon pointed to research myopia in the data.¹⁹⁵ It riveted too narrowly on horizon issues to the exclusion of many other factors that bear on firm value. And firm value, recall, is something beheld differently by the wide variety of shareholder types.¹⁹⁶

Moreover, Cremers and Sepe disagree that the debate is settled.¹⁹⁷ But they are also moving helpfully forward to focus on shareholder time horizon as well as conviction. For example, in their recent symposium article, they found that a higher density of quality shareholders reduces, though only slightly, the value of staggered boards.¹⁹⁸ They say this might reflect that activists apply short-term pressure.

But another explanation is that quality shareholders do not take a blanket approach to staggered boards. The evidence suggests that quality shareholders may slightly favor companies with unitary boards, but companies with staggered boards nevertheless attract

193. Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, *Settling the Staggered Board Debate*, 166 U. PA. L. REV. 1475, 1475 (2018).

194. *Id.* at 1477.

195. *Id.* at 1475.

196. See *supra* text accompanying notes 139–40 (quality shareholders focus on business value, seeking to purchase at a discount, and otherwise seek rational pricing; indexers assume market efficiency; and transients prefer the highest price possible).

197. K.J. Martijn Cremers, Simone M. Sepe & Saura Masconale, *Is the Staggered Board Debate Really Settled?*, 167 U. PA. L. REV. ONLINE 9 *passim* (2019).

198. Cremers & Sepe, *Institutional Investors*, *supra* note 38, at 416.

sizable quality shareholder cohorts.¹⁹⁹ Companies certainly continue to be divided on the right approach.²⁰⁰

The scholarly attempt to settle the board structure sub-debate is consistent with the views of quality shareholders on such issues: context matters, and different companies need different governance features. While on its face such an assertion seems obvious to make and easy to defend, many scholars and most indexers—but not quality shareholders—have assumed that staggered boards are always good or bad. Adding quality shareholders to the debate challenges that assumption.

Second, consider ongoing debate over whether to split or combine the roles of chairman of the board and CEO. Traditionally, the CEO held the board chairman role as well. But in recent years, critics have challenged such a practice. Their theory is that boards elect and oversee the CEO, so having one person wear both hats creates a conflict. Yet that is only one vote on boards with many independent directors, so any conflict can easily be neutralized.

Many corporations thrive when led by an outstanding person serving as both chairman and chief executive, just as others have failed when the roles are split.²⁰¹ Companies are about evenly divided on the practice: about half the S&P 500 split the functions while the other half combine them.²⁰² For their part, quality shareholders appear to think about this case-by-case and, if anything, slightly favor companies that combine rather than split the functions.²⁰³

Finally, consider a case study that illuminates the importance of both horizon and conviction. Professors Riel and Martin of the University of Toronto profiled the example of Unilever. In 2009, hoary old Unilever's share turnover mapped that of other multinationals, plagued by a large portion of shareholders with

199. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8, at 132 (within the S&P 500, sixty-one have staggered boards, of which 14% are in the top 10% of quality shareholder density versus those with unitary boards where 37% are in the top 10%).

200. See Bebchuk, *supra* note 2 (indicating that about half the Russell 3000 companies have staggered boards).

201. To give a dramatic case, the chairman and CEO roles were split at Enron Corporation.

202. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8, at 132 (within the S&P 500, 229 split and 245 combine).

203. *Id.* at 132 (of those splitting, 16% are in the top 10% in terms of quality shareholder density, and of those combining, 28% are in the top 10%).

holding periods of less than one year.²⁰⁴ To CEO Paul Polman, the high level of transients translated into urgent demands for maximizing quarterly profits and daily share prices.

Such a capital markets outlook adversely affected operations, strategy, and reporting. Unilever published quarterly earnings guidance, forming expectations among market watchers. Then, to meet these expectations, division managers cut spending on R&D, information technology, and capital projects.

Polman recognized this flawed strategy. He adopted new policies and clearly communicated these to shareholders and the market. Unilever would cease quarterly guidance and reporting. It would no longer seek to deliver maximum profits each quarter or year but would seek consistent and sustained profits across multiple years. At first, the stock price dropped.

But within two years, it recovered and continued to rise over the next eight years in tandem with sustained profits. In the process, transient shareholders were chased away, replaced by a concentration of long-term holders. As of late 2017, not long before Polman retired, Unilever's largest fifty owners boasted an average holding period of seven years.

Many of these were quality shareholders, but a substantial cohort of indexers were among them.²⁰⁵ In other words, Polman's campaign was only half successful.

In 2018, after Unilever announced plans to move to an Amsterdam-only listing rather than maintain its long-standing dual listing in London, indexers howled. They wanted Unilever to retain its London listing so that it would remain in their favored index. Unilever succumbed to their pressure.

While doing so was consistent with seeking long-term shareholders, the move compromised the other goal of attracting concentrated shareholders—those with conviction. Putting horizon and conviction together is important in practice as well as in theory.

204. See Jennifer Riel & Roger Martin, *How Unilever Won Over Shareholders with Its Long-Term Approach*, *GLOBE & MAIL* (Oct. 13, 2017), <https://www.theglobeandmail.com/report-on-business/careers/management/how-unilever-won-over-shareholders-with-its-long-term-approach/article36538572/>.

205. Among quality shareholders, Unilever has attracted AKO Capital, Gardner Russo Gardner, and Hotchkiss & Wiley. See CUNNINGHAM, *QUALITY SHAREHOLDERS*, *supra* note 8, at 123.

III. PORTFOLIO CONVICTION

Corporate law professors have begun to wade into their version of the hottest debate in finance: passive versus active investing. As referenced at the end of Part I, the debate in finance concerns the relative performance of these two broad approaches to investing.²⁰⁶ In corporate law, the debate concerns the relative incentives and capacities of shareholders in these two broad categories to cast informed votes on corporate matters. All participants in both debates face a huge challenge: the two categories are not self-defining, and the available tools to distinguish between the categories are limited.

Passive usually refers to an investing strategy that buys all stocks in an index, without requiring active decision making concerning which stocks to buy or sell, whereas active denotes everything else. “Everything else” is a huge diverse category, however, encompassing countless alternative investment strategies and styles—value, growth, momentum, chartist, quantitative. Finance researchers deal with this problem by exploring, within “everything else,” any strategies or styles that an investor could use systematically to outperform the market indexes. While that delineation helps researchers to canvass more comprehensively, it may often exclude distinctive strategies of quality shareholders who do not compare performance with annual benchmarks.²⁰⁷

In the nascent legal literature, moreover, the focus to date has been on the indexers, especially the largest ones, and their incentives and capacities, rather than on exploring the various alternative types and their incentives and capacities. For instance, a wave of current scholarship focuses intensively on the incentives and capabilities of the three largest indexers, contrasting those few firms with everything else dubbed “active.”²⁰⁸

While useful to gain insight into the major indexers, such a focus obscures the contributions of rivals and muddies the meaning of any related policy implications. In particular, there is as big a difference between an “active” fund that is long- or short-term as between an active fund that is heavily concentrated (1 to 20 stocks), moderately concentrated (20 to 50), or somewhat diversified (up to

206. See *supra* text accompanying notes 122–32.

207. See *supra* text accompanying notes 106–09.

208. See sources cited *supra* note 3.

100). While delineating every cohort for purposes of legal analysis may be more daunting than hunting for market-beating results in finance, it is relatively easy and highly illuminating to add the quality shareholder. This Part explores how to do so by incorporating perspectives on the quality shareholder into the principal terms of evolving debate in corporate law scholarship about index funds.

A. Theory and Debate

The business model of the large index funds is to develop a broad portfolio of securities, minimize costs, and match the index. Compensation is based on size of the fund rather than performance of the fund, the traditional approach in the investment management industry. Accordingly, indexers strive to increase assets under management (AUM). Beyond that description, corporate law scholars begin to disagree.

The disagreement starts with theory. Recall references to the course of corporate life during the twentieth century.²⁰⁹ The challenge of corporate life was bridging the separation of ownership from control, and the job of corporate law was to mitigate the agency costs that arise when strong managers control companies with weak owners. The rise of institutional investors heralded a new era where such agency costs would be vastly reduced. But experience has disappointed such hopes as institutional investors, holding funds for others, bring agency costs of their own.

Today's scholarly disagreement concerns the magnitude of those costs and what corporate law might do about it. Two main rival theories contend in portraying the index fund sector. One account is the value maximization view. In this account, agency costs are real but modest, as funds have requisite incentives to act on behalf of their investors to monitor investments to assure the best outcomes for their investors. The rival view sees agency costs as large and forbidding, where fund managers face offsetting personal incentives and lack economic incentives to invest in stewardship to improve the performance of particular companies.

Both theories have a certain appeal. Both sides can point to evidence to support their theories. All positions could be improved,

209. *See supra* text accompanying notes 27–34.

however, by adding the perspective of quality shareholders. The following Sections review some leading theoretical positions on incentives of the largest indexers, and related evidence, while adding the perspective of the quality shareholder.

1. Incentives

In a recent book-length article, Professors Bebchuk and Hirst make the case for an agency cost theory of indexing among the largest such funds.²¹⁰ To start, they identify several benefits that index fund managers may obtain from solicitude toward investee managers compared to what their investors would prefer. These include business relationships, avoiding triggering regulatory duties that can arise from taking an adversarial stance such as securities disclosures, and minimizing the risk of regulatory backlash by overplaying their hand against corporate America.

In another long article, Professors Fisch, Hamdani, and Davidoff Solomon counter that such incentives may be neutralized by fiduciary standards and moral norms.²¹¹ For their part, Professors Kahan and Rock add a reputational argument.²¹² They cite the public relations campaigns mounted by leading industry figures, such as the letters directed to chief executives by BlackRock CEO Laurence Fink.

Norms and reputational concerns may constrain behavior, but probably imperfectly and no more than among other shareholder types. For instance, while the largest index funds and their CEOs may have name recognition, that is not true of those who manage funds. In contrast, quality shareholders often put their names on the door, write books, issue newsletters, and speak at conferences.²¹³ They become well known, showing substantial investment in reputation. Quality shareholders form exclusive

210. See Bebchuk & Hirst, *supra* note 3 (120,000 words).

211. Fisch et al., *The New Titans*, *supra* note 3 (60,000 words).

212. Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* (N.Y.U. Sch. L., Law & Economics Research Paper Series, Working Paper No. 18-39, 2019) [hereinafter Kahan & Rock, *Let Shareholders Be*].

213. Individual examples: Chuck Akre at Akre Capital Management; Shelby and Chris Davis at Davis Selected Advisers; Ingrid Hendershot at Hendershot Investments; Tom Russo at Gardner Russo Gardner; Sir John Templeton at Templeton Funds; and Thomas Rowe Price at T. Rowe Price & Co. See CUNNINGHAM, *QUALITY SHAREHOLDERS*, *supra* note 8, Appendix.

membership fraternities and even offer an examination-based certification that is regarded as the toughest in the industry.²¹⁴

On the other side of this debate, presenting the value maximization theory of the largest indexers, stand Professors Kahan and Rock.²¹⁵ In an intricate draft article, they offer an account of the direct incentives that index fund families have to increase the market capitalization of investees: doing so increases AUM. To Kahan and Rock, incentives are measured by the increased fees that follow from increases in AUM. They conclude, “[T]he most important factor by far in determining how much a fund adviser stands to gain from being informed is the size of the holdings.”²¹⁶ On that basis, they say the largest indexers—those with trillions in AUM—have the greatest incentives.

Bebchuck and Hirst respond to Kahan and Rock’s AUM thesis by focusing on individual index fund managers.²¹⁷ Their compensation is based on a tiny percentage of a fund’s AUM, so increasing the value of a particular investee yields little gain for them.

Two more fundamental problems face the AUM thesis from a quality shareholder perspective. First, quality shareholders do not measure themselves by the growth in size of their investees but by their return on shareholders’ equity over long periods of time.²¹⁸ Those may often increase by virtue of a company shrinking in size, as through dividends, buybacks, or spinoffs—not growing market capitalization.²¹⁹ Growth in AUM due to growth in investee market

214. See Julia LaRoche, *11 Horror Stories About the Killer Exam that Wall Streeters Will Be Taking This Saturday*, BUS. INSIDER (May 30, 2013), <https://www.businessinsider.com/cfa-horror-stories-2013-5> (CFA exam); Daren Fonda, *Even Wall Street Pros Have a Tough Time Getting Into This Club*, BARRON’S (Aug. 24, 2018), <https://www.barrons.com/articles/even-wall-street-pros-have-a-tough-time-getting-into-this-club-1535143468> (Value Investors’ Club).

215. Kahan & Rock, *Let Shareholders Be*, *supra* note 212.

216. *Id.*

217. Bebhuk & Hirst, *supra* note 3.

218. See *supra* text accompanying notes 106–09.

219. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8. For instance, The Washington Post Co. in 2015 spun off its Cable One subsidiary, renaming the remaining company Graham Holdings. Cable One began trading at around \$400 per share and today is worth \$1,500. Indexers focused on Graham as a factor in AUM might have balked at this extraordinarily valuable transaction. But capital allocation is a vital topic dear to quality shareholders so often myopically ignored in this way by indexers and their supporters alike. See generally WILLIAM N. THORNDIKE, THE OUTSIDERS: EIGHT UNCONVENTIONAL CEOs AND THEIR RADICALLY RATIONAL BLUEPRINT FOR SUCCESS (2012) (discussing CEOs who excelled at using astute capital allocation to increase their companies’ per-share value).

capitalization does not capture this source of incentives. The absence of such a baseline prevents a comparative assessment of the incentives of the major indexers.

Second, Kahan and Rock's AUM model lacks attention to the important variables included in the research of Bushee and others.²²⁰ These are the variables that delineate the quality shareholder cohort and define its incentives. In Bushee's model, for example, they are average percentage ownership of investees, the percentage of investees representing at least a 5% share of the portfolio, and the average size of each investment.²²¹ The incentives that arise from having such high stakes in a company likely dwarf those of large indexers with relatively small stakes in thousands of companies. Again, in any event, the AUM incentives model fails to offer a way to compare the incentives of quality shareholders.

Professor Fisch and her co-authors offer a different account of indexes' incentives to support their theory of indexer value maximization.²²² They think that indexers compete with other indexers as well as with "active" funds.²²³ They say this competition gives indexers incentives to improve investee corporate governance because such improvements remove the advantages of stock picking. In other words, indexers try to outperform "active" rivals.

Bebchuk and Hirst doubt this creates indexer incentives to invest in stewardship.²²⁴ They explain that people migrate from "active" to passive investing because of the observed difficulty of funds beating market averages. Under this motivation, indexers compete for customers not with active funds but with fellow indexers. True, "active" funds still manage substantial assets, because some do beat their index benchmark, Bebchuk and Hirst theorize. That will remain so even if indexer stewardship increases

Companies may grow merely by retaining and deploying earnings in suboptimal projects, which may help a fund grow its AUM but not drive higher corporate returns to shareholders.

220. See *supra* text accompanying notes 55–58.

221. See *supra* text accompanying note 57.

222. Fisch et al., *The New Titans*, *supra* note 3.

223. Throughout the corporate law literature on the conviction debate, writers routinely juxtapose passive indexers with "active" investors without distinguishing among activists, transients, quality, or other distinctive categories. When examples appear in this discussion, the word "active" is placed in quotation marks.

224. Despite their equally sympathetic view of large indexers, Kahan and Rock also reject Fisch's indirect incentives theory. Kahan & Rock, *Let Shareholders Be*, *supra* note 212.

investee value. In fact, active investors with concentrated ownership in given companies benefit more from indexer efforts targeted to improve such companies, hardly creating indexer incentives to intervene.

Both Fisch's thesis and the Bebchuk-Hirst response suffer from the same problems as Kahan and Rock's AUM thesis: quality shareholders do not measure their performance against annual index performance. Their incentives are entirely different, so such a theory of indexer incentives is inapposite.

Kahan and Rock add another perspective on the incentives debate—one that inadvertently touches on quality shareholders. While agreeing with Bebchuk and Hirst that indexers lack incentives to compete with "active" funds for new business ("inflows"), they say concentrated fund managers may have such incentives. Drawing on the finance literature,²²⁵ they estimate that competitive funds may increase AUM via inflows by 1.3% for every point by which they beat a benchmark index. At certain investment concentration levels, incentives to boost inflows are stronger than those to increase AUM through investee growth alone, they say.

They instance a fund concentrating 3.5% of its portfolio in a single stock. That is the average level among smaller funds, with AUM around \$1.2 billion. For that cohort, inflow-based incentives are 20% larger. On the other hand, they contrast a fund concentrating merely .5% in a single stock—the average level for larger funds, with AUM around \$736 billion. The difference disappears. Overall, Kahan and Rock conclude, the inflow-based incentives of this cohort are slight—low for the smaller firms and scant for the larger ones.²²⁶

But if you change the flawed assumption of AUM growth as an incentive for quality shareholders and make some adjustments that *are* relevant to them, this approach offers some promise. For example, consider medium-size quality shareholders—say with \$25–50 billion in AUM—and concentrated holdings in some companies of 5% to 10%. Even within the AUM-based model, that could spell substantial inflow-based incentives. If also taking account of the actual incentives of quality shareholders—

225. *Id.* at 24 (citing Jonathan Lewellen & Katharina Lewellen, *Institutional Investors and Corporate Governance: The Incentives to be Engaged* 12 (Working Paper, 2018)).

226. Kahan & Rock, *Let Shareholders Be*, *supra* note 212, at 25.

long-term returns on investment and strong reputations among constituents—their incentives could swamp those of the large indexers.²²⁷

Being explicit about the quality shareholder cohort, and its particular incentives that indexers lack, would improve the theoretical debate over the relative incentives of indexers and others to operate as informed shareholders. After all, many skeptics continue to doubt the rationality of an indexer incurring costs of x to increase investee value knowing they would share most of any gain with rivals and net a tiny fraction of x .²²⁸ Kahan and Rock counter that the largest three indexers have stronger incentives than “most” other institutional investors and all but the largest individuals.²²⁹ Quality shareholders are certainly within the referenced population boasting stronger incentives.

2. Capacity

Debate over indexer incentives leads directly to questions about their capacity for informed shareholder conduct. While this aspect of the debate can be measured to some degree, scholars view the same facts differently.

Participants agree that large indexers cast votes at more than 4,000 annual meetings, adding up to more than 30,000 proposals. Champions such as Kahan and Rock stress that most do not matter, and only a few dozen annually are important.²³⁰ They then ask if indexers have the demonstrated capacity to handle those and the question answers itself: no.²³¹

Fisch and her co-authors stress that the large volume of meetings and proposals endows large indexers with substantial economies of scope—each vote produces knowledge useful in other votes.²³² Critics counter that across so many votes, little study can possibly be made, so little knowledge can possibly accrue.²³³

227. See *supra* text accompanying notes 106–09.

228. Kahan & Rock, *Let Shareholders Be*, *supra* note 212, at 12 n.44.

229. *Id.* (emphasis added).

230. *Id.* at 32–33.

231. *Id.* at Section II.E (calling these Type C votes).

232. See Fisch et al., *The New Titans*, *supra* note 3, at 40.

233. See Bebchuk & Hirst, *supra* note 3 (detailing the stewardship resources of Blackrock, Vanguard, and SSGA)

Fisch embraces the widely publicized commitment these funds made to increase their stewardship staffs.²³⁴ But Bebchuk and Hirst find the results underwhelming.²³⁵ They compare staff size – after the vaunted increases – in relation to the number and size of companies to be followed. Among the largest indexers, BlackRock doubled its stewardship staff to forty-five, Vanguard has twenty-one people, and State Street has twelve.²³⁶ Yet these indexers have holdings in more than 11,000 companies each worldwide, and at least 3,000 in the United States alone.

In dollar terms, total stewardship investment by these big indexers is a miniscule fraction of their budgets: about \$13.5 million, \$6.3 million, and \$3.6 million, respectively, all less than one-fifth of 1% – only 0.2% – of total fees and expenses. Even if the staff focused only on the largest companies – say where their stakes exceed \$1 billion – that still includes hundreds of companies. They could only devote two to four person-days per year studying that small portion of their total portfolio.

The following table starkly presents the picture:

Indexers' Limited Stewardship Stakes²³⁷			
	BlackRock	Vanguard	SSGA
Stewardship Staff	45	21	12
Investees Worldwide	11,246	13,225	12,191
Investees U.S.	3,765	3,672	3,117
Maximum Person Day	<4	<2	<2
Stewardship Expense	\$13.5M	\$6.3M	\$3.6M
Total Fees & Expenses	\$9.1B	\$3.5B	\$2.6B

For context, consider the head count at two other companies involved in investment analysis. Moody's, the bond rating agency covering a large swath of capital markets, employs 12,000 people. Among the largest quality shareholders, Capital Research, which keeps up with a far smaller portfolio of companies, employs 7,500.

234. Fisch et al., *The New Titans*, *supra* note 3, at 48–49 (quoting materials of the large indexers, such as BlackRock and Vanguard).

235. See Bebchuk & Hirst, *supra* note 3, at 2076–116.

236. *Id.* at 2077.

237. See *id.* at 2077 (compiling data from Morningstar).

Bebchuk and Hirst find it hard to believe that the limited resources of the large indexers suffice to yield informed opinions on the tens of thousands of shareholder decisions required of an owner of shares in many thousands of companies. Even if Kahan and Rock are right that most are quotidian and few grave, Bebchuk and Hirst say at least a significant portion would require some knowledge that would entail reading the annual report and proxy statement, determining the company's strategic plan and past performance, understanding components of its executive compensation plans, and evaluating pending shareholder and management proposals. Yet the evidence indicates that the big indexers access only 29% of governance-related public filings of their investees.²³⁸

Fisch and her colleagues stress the extensive private engagement the large indexers say they routinely undertake.²³⁹ Bebchuk and Hirst probe the data to find the probabilities and public record pointing to inherent limitations. From 2017 through 2019, the largest indexers reported having multiple annual engagements with only a handful of their investees—3.9% at Blackrock, 2.3% at Vanguard, and 0.6% at State Street; they had just one engagement with another 7.2%, 3.5%, and 5.0%, respectively.²⁴⁰ In other words, over a recent three-year period, these firms had no engagement with the overwhelming majority of the companies they invest in, contrary to their public assertions that some scholars have cited. That is not surprising given that they invest in thousands of companies, and there is little doubt that some of those investees warrant engagement; in contrast, investors who invest in ten to twenty companies can readily engage whenever circumstances warrant.

The implication of the current debate may be that indexer critics would prefer the rest of the investment community—the group so often dubbed “active” without delineation—to seize power in the shareholder voting arena. But at least for Bebchuk and Hirst, that is not the case. They see high agency costs across the investment

238. Peter Iliev, Jonathan Kalodimos & Michelle Lowry, *Investors' Attention to Corporate Governance 3* (Mar. 6, 2019) (unpublished manuscript), <https://ssrn.com/abstract=3162407>.

239. Fisch et al., *The New Titans*, *supra* note 3, at 48.

240. Bebchuk & Hirst, *supra* note 3, at 2087.

community.²⁴¹ The upshot of the indexer critique for them is to create incentives to induce indexers to engage more and become more active. But there is more to the debate, concerning the indexers' favored approach of using formulaic guidelines to cast votes and how different that is from the quality shareholder approach.

B. Guideline Best Practices

All the major indexes, as well as two leading specialist companies that advise the rest of the institutional investor market on shareholder voting, publish guidelines on their views of corporate best practices. Rather than examining each vote in the context of a particular company, these guidelines promote certain precepts for all companies: splitting the roles of board chairman and CEO, annual rather than staggered terms for directors, and simple majority shareholder voting. Scholars have different views on what this approach says about the indexers.

Critics say it reflects the thin staffing that would prevent firms from reaching an informed opinion for each particular company. Just as the large indexers are stretched thin, so too are the two main proxy advisers—Institutional Shareholder Service (ISS) and Glass Lewis. Both operate with lean staffs on low budgets, with just 1,000 employees at ISS and 1,200 at Glass Lewis. Yet they address a huge market: ISS boasts 1,700 institutional clients while Glass Lewis's clients together manage \$35 trillion in assets.²⁴² Their small crews opine on hundreds of thousands of separate decisions annually—ISS addresses 40,000 annual meetings and Glass Lewis addresses 20,000.²⁴³

241. See generally Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017) (distinguishing somewhat between passive indexers and "active" funds then sharply contrasting activists, but never addressing the quality shareholder cohort of long-term concentrated shareholders).

242. James R. Copland, David F. Larcker & Brian Tayan, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry* 1, 2 (Rock Ctr. for Corp. Governance at Stan. U. Closer Look Series: Topics, Issues and Controversies in Corp. Governance No. CGRP-72; Stan. U. Graduate Sch. of Bus., Research Paper No. 18-27, 2018), <https://ssrn.com/abstract=3188174>.

243. The 12,000-person workforce at Moody's, conducting comparable coverage in scope, is ten to twelve times these; the Capital Group team of 7,500, covering a fraction of the scope, is four to seven times as large. *Id.* at 7.

In contrast, proponents of indexers treat the guideline approach as an efficient demonstration of economies of scope.²⁴⁴ Kahan and Rock theorize that the indexers have a special advantage concerning broad market-wide issues to which the guidelines speak, such as the relative appeal of staggered boards.²⁴⁵ They acknowledge, however, that other investors may have an advantage when it comes to firm-specific issues such as a given director's fit for a particular board. Of course, few issues are purely firm-specific (a specific question about one company may almost always be presented by at least some others) or purely issue-specific (general policy on staggered boards might still vary for different companies), but they think the degree of importance varies and can be delineated.²⁴⁶

One concern with the guideline method, however, is it condones a once-size-fits-all approach to corporate governance. While Kahan and Rock deny holding any such view,²⁴⁷ others come closer to countenancing it. For example, Fisch and her colleagues say indexers compete by "engag[ing] in broad-based efforts to improve the *overall performance of the market*, . . . address[ing] cross-cutting issues such as corporate governance, risk management, sustainability, and cybersecurity."²⁴⁸ That is notable for its suggestion that, rather than trying to maximize the prosperity of

244. Kahan & Rock, *Let Shareholders Be*, *supra* note 212, at 35. Kahan and Rock make this point favoring quality shareholders on certain issues: "Fund families weighted towards active strategies with more concentrated portfolios will tend to have relatively stronger incentives to develop company-specific information." *Id.* Perhaps—but here's a place where adding long-term would help—quality shareholders yes, transients not so much.

245. Consider, on the other hand, the contentious debate on staggered boards described earlier. See *supra* text accompanying notes 189–98.

246. Characteristic of the literature in this debate, *supra* text accompanying notes 207–08, Kahan and Rock theorize that indexers have an advantage on broad issues while "active" funds benefit most from company-specific votes—without distinguishing between transient and quality. Similarly, they say index funds "tend to hold stock over longer periods of time than actively-managed funds." Kahan & Rock, *Let Shareholders Be*, *supra* note 212, at 36. This is true of transients but not of quality shareholders.

247. Kahan & Rock, *Let Shareholders Be*, *supra* note 212, at 34. "We do not mean to say that a staggered board is necessarily good or bad for all companies, just that it is likely to be good or bad for certain types of companies, and thus that the only relevant company-specific information is what type of company it is." *Id.* at 34 n.100. They add that the distinction "is highly relevant in determining incentives to become informed. While incentives to obtain company-specific information derive primarily from one's holdings in a single company, incentives to obtain issue-specific information derive from one's holdings in all companies where a vote on the issue has to be cast." *Id.* at 34.

248. Fisch et al., *The New Titans*, *supra* note 3, at 25 (emphasis added).

each given company in the index, indexers seek to get the highest market return.

In developing their theory of the value indexers add to corporate governance, Fisch and her colleagues cited several empirical finance articles showing an association between high indexer density in a shareholder base and various governance features the indexers favor, such as more independent directors, fewer takeover defenses, and equalized shareholder voting rights.²⁴⁹ But Bebchuk and Hirst pointed out an uncited subsequent paper reporting similar research revealing that such high indexer density is associated with certain reforms indexers disfavor, such as CEOs becoming chairman.²⁵⁰

No issue is so generic as to be universal – not even the ritualistic shareholder ratification of an auditor of the company's financial reports.²⁵¹ The same is true for a wide variety of guideline practices whose utility and value varies by company and is heavily debated in the literature.²⁵² That's certainly the quality shareholder view. Among the best illustrations of the stakes and the different approaches between indexers and quality shareholders concerns the central nervous system of corporate life: directors and boards, discussed next.

C. Directors and Boards

Corporate law puts boards of directors at the center of corporate governance.²⁵³ Corporate law empowers shareholders to elect directors. It is perhaps the shareholders' most consequential decision. Yet approaches to this critical issue vary widely between

249. *Id.* at 26 n.38 (citing, among other research, Ian Appel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111 (2016)).

250. See Cornelius Schmidt & Rüdiger Fahlenbrach, *Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?*, 124 J. FIN. ECON. 285, 293–94 (2017). Another criticism of asserting an association between indexer density and their favored policies, like reducing takeover defenses, is that many other informed participants contend that such defenses are sometimes desirable and should be evaluated case-by-case. See Sharon Hannes, *The Hidden Virtue of Antitakeover Defenses*, 24 CARDOZO L. REV. 1903, 1931–34 (2003); Sharon Hannes, *The Market for Takeover Defenses*, 101 NW. U. L. REV. 125, 142–70 (2007).

251. See, e.g., J. Robert Brown, Jr., *The Politicization of Corporate Governance: Bureaucratic Discretion, the SEC, and Shareholder Ratification of Auditors*, 2 HARV. BUS. L. REV. 501, 517 (2012).

252. E.g., *supra* notes 189–98 and accompanying text (staggered boards); *supra* notes 199–203 and accompanying text (CEO-chairman split or combined).

253. E.g., DEL. CODE ANN. tit. 8, § 141(a) (2020).

indexers and quality shareholders. It would illuminate the indexing debate to compare and contrast these two approaches. The following first reviews the formulaic approach of the indexer guidelines and second the analytical approach of the quality shareholder.²⁵⁴

1. Indexer guidelines

Consider the approach of the leading proxy adviser, ISS. ISS opens its discussion of the board of directors not with statements of competence or corporate stewardship, but with “[f]our fundamental principles [that] apply when determining votes on director nominees.”²⁵⁵ These are enumerated as independence, composition, responsiveness, and accountability.²⁵⁶ Only the assessment of “responsiveness” is contextual—voting “case-by-case.”²⁵⁷

On independence, ISS makes three prescriptions: (1) a majority of directors must be independent; (2) the board must have three standing committees operating under formal charters and staffed only with independent directors—audit, compensation, and nominating; and (3) there must either be a lead independent director or an independent chairman (not also serving as an executive officer).²⁵⁸

Many such rules have become commonly accepted in recent decades, but the empirical evidence on their economic value remains inconclusive.²⁵⁹ Consider the issue of director independence.²⁶⁰ Some

254. Indexer critics note a further anomaly: indexers seldom nominate directors. In fact, during the past five years, none of the largest three indexers have formally nominated a single director to any public company board. See Bebchuk & Hirst, *supra* note 3, at 2098. In contrast, quality shareholders frequently suggest nominees, and quite a few have served on boards themselves. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8 (chapter 3).

255. INSTITUTIONAL S'HOLDER SERVS., PROXY VOTING GUIDELINES 8 (2019) [hereinafter ISS GUIDELINES].

256. *Id.*

257. *Id.* at 12.

258. *Id.*

259. See *supra* notes 199–203 and accompanying text (addressing the issue of the role of the chairman/CEO). The listed committees are functionally required by law; other committee subjects are mentioned *infra* in text accompanying notes 274–75.

260. See, e.g., Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999) (analyzing how board composition affects firm performance); Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002) (finding that firms with more independent boards do not outperform other firms).

evidence suggests a board's independence is less important than its active engagement.²⁶¹ Other evidence suggests that certain kinds of outside directors improve the performance of certain functions, such as adherence to accounting requirements.²⁶² But, clearly, there is a trade-off between the expertise of inside directors and the independence of outside directors.²⁶³

On composition, ISS again states three rules: (1) directors should have diverse skills that add value to the board, rather than duplicating backgrounds from particular viewpoints, ideally presented in a graphical skills matrix to illustrate; (2) regular meeting attendance is expected, defined as at least 75% of meetings of the full board and committees; and (3) attention is expected, determined by caps on the number of public company boards individual directors may serve – five in general or two for CEOs.²⁶⁴

Critics challenge these composition directives as intrusive and formulaic. Taking (2) and (3) first, attendance and attention are clearly necessary, but not sufficient, to determine a valuable board member. Rules of thumb are useful, but that is not how these rules operate. That is why the board of directors' section of so many corporate websites portray check marks ticking off all the governance formulas that major indexers and proxy advisers champion. Attention is important, but caps are clearly arbitrary.²⁶⁵

On ISS's first composition rule regarding accountability, it calls for regular director elections, opposes staggered terms, and believes in shareholder removal power, with or without cause. But state corporate law permits all these and many other approaches to director election and removal and leaves it to companies to choose those best suited for their circumstances. As we have seen, there are good arguments to evaluate these on a case-by-case basis.²⁶⁶

261. 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 (1998).

262. See Lawrence A. Cunningham, *Rediscovering Board Expertise: Legal Implications of the Empirical Literature*, 77 U. CIN. L. REV. 465, 479–81 (2008).

263. See Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 493 (2008).

264. ISS GUIDELINES, *supra* note 255, at 11.

265. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8, at 8 (giving the example of ISS opposing nomination of a widely-recognized executive and director for exceeding the board service limit due solely to the fact that an incumbent company was divided into two separate entities).

266. E.g., *supra* notes 189–98 and accompanying text (staggered boards); *supra* notes 199–203 and accompanying text (CEO-chairman split or combined). A final prong of ISS's accountability plank prescribes that each board undertake regular performance reviews

2. Comparing quality

Warren Buffett has often expressed his views on ideal directors and boards—ideas that have a wide following among the rest of the quality shareholder cohort.²⁶⁷ They seek directors with a shareholder orientation, business savvy, and interest in the particular company and its stewardship.²⁶⁸ Particular director traits and the specific context of a given company are more important than following general formulas or perceived best practices.

The number one question quality shareholders want to know about any director candidates, however, is whether they are shareholder oriented. That is, all directors should act as if there is a single absentee owner and do everything reasonably possible to advance that owner's long-term interest.²⁶⁹

This is not a mandate for the immediate maximization of shareholder value, but rather a mentality to evaluate every decision from the shareholder perspective. To that end, it is desirable for directors to buy and hold sizable personal stakes in companies they serve, so that they truly walk in the shoes of owners.²⁷⁰

The board's most important job is selecting an outstanding CEO. If the board secures an outstanding CEO, it will likely face few other major problems. All CEOs must be measured according to a set of performance standards. A board's outside directors must formulate these standards and regularly evaluate the CEO in light of them—without the CEO being present.²⁷¹ Standards should be tailored to the particular business culture but should stress fundamental baselines, such as returns on shareholder capital and

of itself. This is another fashion in corporate governance that is reinforced by consulting firms offering the service. CHRISTOPHER D. MCKENNA, *THE WORLD'S NEWEST PROFESSION: MANAGEMENT CONSULTING IN THE TWENTIETH CENTURY* (Louis Galambos & Geoffrey Jones 2006). The task of self-evaluation, while important, is challenging, and observers are justified in skepticism about the results.

267. See Lawrence A. Cunningham, *Warren Buffett's Ten Commandments for Directors*, NACD DIRECTORSHIP, July–August 2017, at 28; Lawrence Cunningham, *Warren Buffett's Ten Commandments for Directors*, EUR. FIN. REV. (July 27, 2017), <https://www.europeanfinancialreview.com/warren-buffetts-10-commandments-for-company-directors/>; Lawrence Cunningham, *Warren Buffett's 10 Commandments for Running a Successful Business*, CNBC (July 17, 2017), <https://www.cnbc.com/2017/07/17/warren-buffetts-10-commandments-on-boardroom-power-and-success.html>.

268. See BUFFETT, *THE ESSAYS*, *supra* note 17.

269. *Id.* at 45.

270. *Id.* at 31–32 (Berkshire's owner-related business principles, number 2).

271. *Id.*

progress in market value per share over multiple years. Above all, directors should evaluate the CEO's record on capital allocation measured against a hurdle rate it sets.²⁷² If the CEO's performance persistently falls short of the standards set by the directors, then the board must replace the CEO. The same goes for all other senior managers boards oversee, just as an intelligent owner would if present.

In addressing these problems, the director's actions must be fair, swift, and decisive. Directors who perceive a managerial problem should immediately alert other directors to the issue. If enough are persuaded, concerted action can be readily coordinated to resolve the problem.

Here, too, shareholders can play a role. Companies can make their directors available to their largest long-term quality shareholders.²⁷³ These representatives can discuss issues put to shareholder votes that affect enduring value. A few influential quality shareholders, acting together, can effectively reform a given company's corporate governance simply by withholding their votes for directors who were tolerating odious behavior.

On board committees, finally, corporate law requires that boards approve major acquisitions and dividends, and as a practical matter, approve share buyback programs.²⁷⁴ Along with such approvals, good practice dictates that the board's principal role is setting applicable hurdle rates, for reinvestment and acquisitions.

Companies wishing to make capital allocation a priority could consider whether to create a board committee with this oversight. At S&P 500 companies, boards maintain an average of four committees, and about one-third include a committee on capital allocation, finance, or investment.²⁷⁵ Charters might call for post-investment reviews on all important allocations, especially organic growth initiatives, acquisitions, and share buybacks.

272. See *Case Studies of Companies That Do Capital Allocation Right*, MOI GLOBAL (Jan. 15, 2019), <https://moiglobal.com/phil-ordway-201901/>.

273. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8 (chapter 8).

274. E.g., DEL. CODE ANN. tit. 8, § 154 (2020) (dividends); § 160 (repurchases technically do not explicitly require board approval but statutory rules violations expose directors to personal liability); § 251 (mergers).

275. See *supra* note 272.

With capital allocation being the central driver of business value, from the quality shareholders' analytical perspective, it is natural that this cohort would discuss the idea of a board committee on the subject. The indexer guidelines, of course, do not.

3. A note on activists

A turn to the subset of quality shareholders who go activist is in order. Activist shareholders regularly identify and recruit able director nominees to serve on boards of corporations they target. These director nominees are often experts in the relevant industry or on aspects of perceived board weaknesses, such as corporate governance. They may often be the kinds of directors quality shareholders would seek and nominate themselves. But the context where such nominations arise can compromise actual or perceived stewardship.

First, there is longstanding concern that directors appointed as the result of activist support will be more beholden to the activist than to the other shareholders. This concern is constrained somewhat by a director's fiduciary duties, which require acting for the corporation, not any particular shareholder.

But circumstances can aggravate the problem. For instance, some activists have offered their nominees bonuses for achieving stated corporate results during their tenure, including certain stock price levels. Such "golden leashes," as they are called, increase the risk that the director is beholden to the sponsor.²⁷⁶

In addition, a payout set based on stock price could influence important business judgments, such as optimal borrowing levels and whether to make or accept acquisition offers. For these reasons, special bonuses for certain directors risk creating board factions and infighting.

Second, when appointed as the result of a settlement, outside normal governance procedures, the other shareholders do not get a vote. Such arrangements can lead to board members that appeal unduly to the activist and incumbents.

276. See Gregory H. Shill, *The Golden Leash and the Fiduciary Duty of Loyalty*, 54 UCLA L. REV. 1246 (2017).

One solution to this problem is to put settlements to votes of the other shareholders.²⁷⁷ This would assure appointment of directors with consensus support, as well as validate any other aspects of the settlement, such as committee assignments, director removal, terms and term limits, and corporate governance guidelines.²⁷⁸

In sum, the indexing debate over incentives, capacity, and “guideline” approach to governance is vital. It can be enriched by adding the perspective of the quality shareholder. All of this matters, above all, because of the increasingly important role shareholders play in corporate governance. The frequency and significance of shareholder balloting and the fragmentation of shareholder types is what leads to ultimate debates in corporate law concerning shareholder voting rules, to which we turn next.

IV. SHAREHOLDER VOTING RULES

State corporate law requires corporations to submit certain matters to a shareholder vote.²⁷⁹ These matters include election and removal of directors, bylaw or charter amendments, mergers, substantial asset divestments, and dissolution.²⁸⁰ Federal securities law supplements these state laws by regulating the process of shareholder voting,²⁸¹ and sometimes requiring votes, most notably

277. John H. Matheson & Vilela Nicolet, *Shareholder Democracy and Special Interest Governance*, 103 MINN. L. REV. 1650, 1694 (2019). These authors start with the premise that shareholder democracy is a virtue, manifested in improved governance or voting on staggered boards, majority elections, say on pay, and proxy access. They are concerned that settlement of activist threats impairs democracy. It operates outside main governance mechanisms through private means advancing private agendas—of both activists and target boards against the rest of the shareholders. They analogize to other similar settings—threats to corporate control to interested director transactions—to offer a statute making such settlement agreements void unless approved by a majority of the other shares.

278. Finally, investors with holding periods less than one year cast votes in annual elections, despite the fact that they will not continue to be a shareholder for the directors’ full term. Even investors with holding periods less than two or three years who cast votes in electing staggered boards will not be around for as long as the directors they elect.

279. See Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 420 (2006).

280. E.g., DEL. CODE ANN. tit. 8, § 211 (2020) (director elections); § 242 (charter amendments); § 251 (mergers); MODEL BUS. CORP. ACT § 11.04 (AM. BAR FOUND. 2003) (mergers); § 10.03 (charter amendments); § 10.20 (bylaw amendments).

281. 17 C.F.R. § 240.14(a) (2019).

on executive compensation.²⁸² Managers or shareholders can make additional proposals calling for a shareholder vote on topics ranging from interested transactions to disclosures about climate change.²⁸³

State corporate law provides that each corporate share is entitled to one vote on all such matters, unless a company's charter adopts a different rule.²⁸⁴ State law permits a wide variety of alternative voting regimes, including several classes of shares with different voting rights, shares without votes or with multiple votes, as well as shares that accrue votes when held for long periods or that enjoy fewer votes when held by a large block owner.²⁸⁵ Although federal securities laws defer almost entirely to state corporate law on voting rules, stock exchange rules limit some of this variation, at least for companies already listed.²⁸⁶

While state corporate law grants vast power to boards of directors to oversee and manage a corporation,²⁸⁷ these shareholder voting rules give shareholders a significant voice on many consequential issues. In recent years, the number and importance of matters submitted for shareholder voting have both increased.²⁸⁸ Fragmentation of the shareholder base has accentuated the importance of shareholder voting, as this is the favored route for shareholder activists to shape corporate policy and an occasion when indexers wield their power. These forces have combined to produce experimentation with alternative voting arrangements.

Although the baseline voting rule remains one-share, one-vote, more companies have switched to alternatives, and debate has ensued.²⁸⁹ In this debate, the traditional rule is heralded as a

282. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951(a)(2), 124 Stat. 1376, 1899 (2010); Securities Exchange Act of 1934, 15 U.S.C. § 78n-1(a)(2).

283. See Lisa M. Fairfax, *Social Activism Through Shareholder Activism*, 76 WASH. & LEE L. REV. 1129 (2019).

284. E.g., DEL. CODE ANN. tit. 8, § 212(a).

285. See *supra* note 279.

286. See Paul Mason, Usha Rodrigues, Mike Stegemoller & Steven Utke, *Does Shareholder Voting Matter? Evidence from the Takeover Market*, 53 WAKE FOREST L. REV. 157, 171 (2018).

287. E.g., DEL. CODE ANN. tit. 8, § 141(a).

288. See Fisch et al., *The New Titans*, *supra* note 3, at 40.

289. E.g., Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote, and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445 (2008); Paul H. Edelman & Randall S. Thomas, *Corporate Voting and the Takeover Debate*, 58 VAND. L. REV. 453, 464 (2005).

democratic gold standard, against which all alternatives must be measured. This Part reviews the three alternatives that have attracted the most attention: dual class, tenured, and exclusionary, putting each in context, and assessing the pros and cons.

The review leads logically to a novel alternative, which I propose, that increases the power of long-term committed owners—quality shareholders. I dub this regime “quality voting.” Besides logical closure in relating the relevant elements of the debate to voting rules, quality voting will appeal to companies interested in attracting higher densities of quality shareholders.

A. Dual Class: Anti-Activist

The one-share, one-vote regime is easiest to conceptualize and implement in a company with a single class of stock outstanding. Every share of that class has one vote, and all other shareholder rights are the same, as to matters such as dividends or liquidation rights. But state corporate law has long permitted companies to have more than one class of stock, with variable voting and other rights, so long as the rights of each class are the same within the class.²⁹⁰ This approach is valuable to enable issuing preferred stock like, for instance, a security that blends features of common equity with debt.²⁹¹

While allowable under state corporate law, maintaining two classes of common stock has sparked controversy since at least 1925. The details of each dual class structure vary, but the general design grants greater voting power to one class than to the other. Participants all see a trade-off between the increased incentives of those with the greater voting power to make value-enhancing decisions and the decreased monitoring capability of those with lesser voting power. People disagree, often strongly, about the net effects of the trade-off. This Section charts the regulatory path of this debate back to 1925 through today, stressing how a greater emphasis on the distinctive role that quality shareholders play would add to this debate.

290. *E.g.*, MODEL BUS. CORP. ACT. § 8.04 (AM. BAR FOUND. 2003).

291. See Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (and Why We Should Care About It)*, 51 BUS. LAW. 443, 445 (1996).

1. Law and practice

In a famous 1925 offering, Dodge Brothers, Inc. adopted two classes of stock with different voting rights.²⁹² One class had multiple votes per share, while the other had the usual one vote per share. A public howl of protest erupted, as the era's populists condemned the lopsided arrangement. Critics observed that the owner of the high-vote stock held shares worth only \$2.25 million in a company with a market value of \$130 million – yet controlled a majority of the voting power.

In this era, such matters were governed entirely by state corporation law, though this episode contributed to the forces that led to enacting of federal securities laws in 1933 along with exploring how stock exchange listing rules could supplement state corporate law.²⁹³ The real issue with such dual class capital structures is that they vest control in a group without matching economic risks: despite equal investments, one class has more votes per share than the other. The controlling class is insulated from short term pressure but also from accountability.

In the aftermath of the Dodge Brothers offering, the stock exchanges barred listing of new companies using multiple classes of stock. That ban remained in effect through 1985. The New York Stock Exchange granted a few waivers, with conditions, particularly when founders showed special skills or vision warranting such enhanced power.²⁹⁴ Other exchanges, such as Nasdaq, also banned dual class subject to conditions such as a minimum portion of minority board seats, a maximum ratio of control shares to minority shares, and anti-dilution protections.

In the late 1980s, the dual class structure's voting arrangement captured newfound public attention after many boards began to use it to defeat unwanted tender offer bids.²⁹⁵ In a common practice,

292. See Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687 (1986).

293. See John C. Coffee, *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 37 (2001).

294. For instance, in 1980 it listed Nike Inc., whose shares were identical except that those held by founder Phil Knight could elect three-fourths of the board. Knight said he would not have taken the company public otherwise. Knight's structure remained in place for decades, even after his retirement. See Pamela Park, *Nike Founder Maintains Control Despite Retirement*, WESTLAW CORP. GOVERNANCE DAILY BRIEFING, July 6, 2015.

295. See Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 3, 44 (1988).

a company facing a threat to control would recapitalize by offering to replace one existing class of stock with two new classes. One of the new classes offered low voting rights but high dividends while the other offered the reverse.²⁹⁶

As boards making such an offering intended, managers and other pro-management shareholders traded their shares for the high vote class while public shareholders, preferring cash dividends to abstract voting rights, went for the low vote class. While state corporate law allowed such a gambit, the SEC regarded the practice as coercive. In 1989, it adopted a federal rule prohibiting stock exchanges from listing companies proposing dual class capital structures.²⁹⁷

A federal court struck the SEC's rule on administrative grounds.²⁹⁸ But the exchanges nevertheless adopted the listing rules, and they remain in effect.²⁹⁹ These rules apply to existing companies, barring recapitalizations, but not to newly listed companies with dual class structures upon initial public offerings (IPOs). Dual class structures have been particularly appealing to new listings for technology companies, with a wave of such offerings occurring in the mid-2000s as the tech sector rallied and again in the last few years since 2017. Today, some 250 listed companies maintain dual class capital structures.³⁰⁰

2. Debate and data

In the longstanding debate, proponents of dual class argue that entrepreneurs need to retain voting control to protect their companies from intense, short-sighted pressure of activist shareholders. The reasoning follows, however, that the founder's "special sauce" offers initial value but tends to fade with time and depends on consistent personal engagement.

296. See Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 COLUM. L. REV. 979 (1989).

297. SEC Rel. Nos. 34-25891, 34-25891A (July 1988).

298. *Bus. Roundtable v. SEC*, 905 F.2d 406, 407-08 (D.C. Cir. 1990).

299. See Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L. Q. 5675 (1991).

300. See COUNCIL OF INSTITUTIONAL INVESTORS, DUAL CLASS COMPANIES LIST (2017) [hereinafter CII MULTI-CLASS PAPER], [https://www.cii.org/files/3_17_17_List_of_DC_for_Website\(1\).pdf](https://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf) (culled from Russell 3000 companies). Actually, quite a few have multiple classes of stock with varying voting rights, so they are "multiple class" capital structures, but the phrase "dual class" is most commonly used to capture all variations.

More recently, the debate has come to focus on duration: people could accept the structure as long as it wasn't permanent.³⁰¹ The issues became how long would the dual class terms endure, and under what circumstances might they cease? Before 2000, nearly two-thirds of dual class offerings had no sunset provisions. But expiration terms have become common, whether at fixed times such as five to ten years or upon events such as the founder's death or incapacity.³⁰²

Despite such compromises, extreme cases arise that lead to extreme reactions. Take the 2017 IPO of Snap Inc., whose public shares carried no voting rights. Many observers fulminated.³⁰³ Some campaigned for the SEC or stock exchanges to ban the practice.³⁰⁴ Although authorities refrained, advocates persuaded certain market index compilers to exclude such companies from their indexes,³⁰⁵ adding a new force in corporate governance.³⁰⁶

Advocates for dual class take a different view. As Professor Lund explains, the debate over nonvoting stock—and dual class generally—pits critics concerned that the approach impairs accountability against proponents who stress the long-term value.³⁰⁷ She then explored how such capital structures segment the shareholder base into informed and uninformed investors.³⁰⁸ Informed investors are better motivated to support optimal governance for long-term value and may even pay a premium to own higher-voting stock.³⁰⁹ Companies catering to different

301. See Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585 (2017).

302. See Jill Fisch & Steven Davidoff Solomon, *The Problem of Sunsets*, 99 B.U. L. REV. 1057 (2019) (protesting calendar expiration dates though willing to accept event-driven terminations).

303. CII MULTI-CLASS PAPER, *supra* note 300 (calling the Snap IPO “egregious”). For a calmer, intellectual approach, see Amy Deen Westbrook and David A. Westbrook, *Snapchat's Gift: Equity Culture in High-Tech Firms*, 46 FLA. STATE U. L. REV. 861 (2019).

304. CII MULTI-CLASS PAPER, *supra* note 300 (reporting numerous investor requests to major index providers to exclude multi-class structures).

305. *Id.* (reporting that FTSE Russell excludes any company whose share float is less than 5% of total voting power; S&P Dow prospectively excludes any company adopting multi-class).

306. See Scott Hirst & Kobi Kastiel, *Corporate Governance by Index Exclusion*, 99 B.U. L. REV. 1229 (2019).

307. Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687 (2019).

308. *Id.* at 696.

309. *Id.* at 698.

shareholder types with such tailored share offerings therefore increase firm value, she says.³¹⁰

Turning to the evidence, it does not support a flat ban on dual class structures nor a universal endorsement of them. First, despite being excluded from some indexes, many companies continue to offer them and many shareholders continue to buy them.³¹¹ The number and percentage of newly listed companies with dual class structures has not changed much³¹²—though the total market capitalization of such companies has fallen substantially.³¹³ The frequency and duration of sunset provisions have not moved much either—about one-fifth of new dual class structures continue to have sunsets, typically after ten years.

Second, many dual class structures are carefully tailored to suit individual corporate and shareholder circumstances. For example, about fifteen companies use complex formulas to allocate corporate power, and another fifteen provide for specific allocations of board seats, some by number of slots and others by percentage.³¹⁴ Several adjust the voting rules on extraordinary matters such as mergers, either reducing the super-voting shares to one vote or increasing the other class to one vote.³¹⁵

Third, and most important for this Article's thesis: quality shareholders often embrace companies with dual class structures. Among companies with dual class structures, most attract a high density of quality shareholders.³¹⁶ One reason for this appetite,

310. *Id.* at 696. Distinguishing between informed and uninformed shareholders is useful to probe shareholder base, cultivation, and related policies. Standing alone, however, the attribute is difficult to test. Other behavioral categories probe this factor, however, particularly the combination of horizon and conviction.

311. See *Dual-Class IPO Snapshot: 2017–2019 Statistics*, COUNCIL OF INSTITUTIONAL INVS. (June 2019), [https://www.cii.org/files/2019%20Dual%20Class%20Update%20for%20Website%20FINAL\(2\).pdf](https://www.cii.org/files/2019%20Dual%20Class%20Update%20for%20Website%20FINAL(2).pdf).

312. *Id.* (19%, 11%, and 26% in 2017, 2018, 2019 (through first half), respectively).

313. *Id.* (49%, 17%, and 15%).

314. See CII MULTI-CLASS PAPER, *supra* note 300 (culled from Russell 3000 companies). For instance, at Forest City Realty Trust, Graham Holdings, Madison Square Garden, Scholastic, and Scripps, one class is entitled to elect a majority of the board, typically two-thirds, while another can elect the rest. Some have plain vanilla terms—more votes on all matters to one class than another, including some fifty companies within the Russell 3000 that have at least one class of stock without any voting rights. *Id.*

315. *Id.* (examples: News Corporation, Sinclair Broadcast, Sonic Automotive, Virtu Financial).

316. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 8. The analysis compares CII's list of 225 companies with my ranking of companies based on the density of quality

particularly in contrast to the indexers' universal condemnation: a categorical condemnation of dual class capital structures ignores their utility in specific scenarios.³¹⁷

In fact, one leading voice in the quality shareholder community publishes an investment advisory entitled "index orphans."³¹⁸ It highlights investment opportunities among excellent companies expelled from the indexes for various reasons, including thanks to having dual class structures.

As this evidence suggests, debates over the merits of dual class would benefit by considering views of the quality shareholder cohort.

B. Tenured Voting: Anti-Transient

Scholars whose normative goal is to encourage long-term share ownership have recently advocated for increasing the voting power of long-held shares. This concept—synonymously called tenured voting, time-weighted voting, or time-phased voting—prescribes that a share's voting power is increased after it has been held for a given number of years.

A common approach grants four votes instead of one to each share held longer than four years. When those shares are sold, they revert back to one-vote shares. Designs vary to suit, with differences in the definitions of short and long term (upping votes after three, five, or ten years say), reward increments (adding one vote per two years or two votes per one year), and matters covered (all matters coming to a vote or only designated matters, such as mergers).³¹⁹

In theory, by rewarding long-term ownership, average holding periods should rise, and stock volatility should fall. From the

shareholders in their shareholder base. In particular, 135 companies appear on both lists. Among those, 64% appeared in the top half for quality shareholder density.

317. Adopters include family companies (such as Tootsie Roll Industries); entrepreneur firms (such as Tilly's); and those whose industries demand a long-term focus, such as journalism (New York Times Co.), spirits (Brown Forman), and finance (Houlihan Lokey). See *Dual-Class IPO Snapshot: 2017–2019 Statistics*, *supra* note 311.

318. See BOYAR RESEARCH, 43 BOYAR'S INDEX ORPHANS 1 (Oct. 12, 2017). Boyar has identified some 750 public companies of this sort—all with market capitalizations exceeding \$1 billion and 60 exceeding \$10 billion. Examples include IAC/InterActiveCorp, Axalta Coating Systems, Madison Square Garden Company, and MSG Networks.

319. See Rock, *Eugenics*, *supra* note 79, at 901 ("Each implementation can have a different effect on the shifting of influence among the shareholding population.").

shareholders' viewpoint, tenured voting remains as democratic as one-share, one-vote: all shares and shareholders enjoy identical opportunities to gain enhanced voting rights.³²⁰

A major and underappreciated problem, however, is that holding period length is an imperfect proxy for wisdom or good judgment.³²¹ After all, if long-term shareholders are indexers with insufficient interest in particular companies while newer shareholders are prepared to engage productively, tenured voting backfires.³²²

While the emerging literature is increasingly robust, most of the analysis has focused on the horizon effects of tenured voting, with limited attention to this issue of conviction. This subsection reviews the prevailing literature while stressing that an equal emphasis on conviction should inform the debate over tenured voting.

1. Law and theory

Unlike dual class, only a dozen U.S. public companies have ever adopted tenured voting, though laws in France and Italy since 2014 have required it for many public companies there.³²³ As a result, far less scholarly attention had been paid to tenured voting until recent years.³²⁴ Interest in tenured voting was sparked by a series of major

320. See *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977).

321. See Rock, *Eugenics*, *supra* note 79, at 902.

322. See Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CALIF. L. REV. 1671, 1718–19 (1985) (among the earliest criticisms, calling tenured voting “problematical” and a “showstopper” against hostile takeover bids since shares, upon purchase by hostile bidder, would lose voting power for several years, longer than any could wait, making this anti-takeover defense “immovable”).

323. In France, lawmakers in 2014 made tenured voting the default for listed French companies, unless shareholders vote to opt out of it. Many companies, including half the largest listed companies, have been using tenured voting, with a two-year minimum holding period. Early empirical results suggest considerable value associated with tenured voting—called loyalty shares in France. See François Belot, Edith Ginglinger & Laura T. Starks, *Encouraging Long-Term Shareholders: The Effects of Loyalty Shares with Double Voting Rights* (Université Paris-Dauphine, Research Paper No. 3475429, 2019), www.ssrn.com/abstract=3475429. Companies opting out of loyalty shares suffered a negative market reaction, while those adhering to tenured voting enjoyed a positive market reaction. The theory? Loyalty shares encourage costly monitoring by long-term shareholders, providing potential benefits to all shareholders.

324. This assertion is based on a Lexis search in the law review library for “time-phased voting” or “time-weighted voting” or “tenured voting.” Aside from a flurry of references during the period surrounding the SEC’s intervention concerning dual class recaps, scattered and indirect references appeared in the following years during that period (one per year

articles led by Lynne Dallas, appearing in 2012, 2016, and 2017.³²⁵ Since then, in addition to numerous passing references, two important articles on shareholder cultivation treated the innovation carefully,³²⁶ and two more recent articles take the topic up head-on.³²⁷

Most of this literature reviews the legal authority to permit tenured voting. These discuss state corporation law as well as stock exchange listing rules – the federal securities laws having virtually no role since the SEC’s aborted flirtation with intervening in the dual class context.³²⁸ The consensus is overwhelming that state corporation law, certainly in the leading state of Delaware, authorizes this and many other variations of voting arrangements.³²⁹

Two landmark cases support this consensus conclusion, one by analogy and one directly. In the analogy case, *Providence & Worcester Co. v. Baker*,³³⁰ the court upheld a scaled voting scheme where voting power varied with a shareholder’s stake – in this case, the greater the stake, the lower the voting power.³³¹ Plaintiffs challenged the scheme under a state corporate statute requiring uniform voting powers by class.³³² In rejecting this challenge, the court reasoned that the provision applied equally to every share,

unless otherwise noted): 1999, 2000, 2002, 2004, 2005 (three times, all in lists of examples), 2006, 2007 (two times), 2008 (two times), 2009, and 2010.

325. Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265 (2012); Dallas & Barry, *supra* note 9; Lynne Dallas, *Is There Hope for Change? The Evolution of Conceptions of “Good” Corporate Governance*, 54 SAN DIEGO L. REV. 491 (2017).

326. See Belinfanti, *supra* note 64; Rock, *Eugenics*, *supra* note 79.

327. See Berger et al., *supra* note 4; Edelman et al., *supra* note 4.

328. See Rock, *Eugenics*, *supra* note 79, at 902 (“[I]t is also permissible under federal securities regulation. . . . Federal securities law takes no official position regarding departures from one-share, one-vote.”); Edelman et al., *supra* note 4.

329. See DEL. CODE ANN. tit. 8, § 212(a) (2020) (making one-share, one-vote the default rule and authorizing substantial tailoring, so long as consistent with other provisions of the statute, by the board alone before a stock sale and by board-shareholder approved charter amendment afterwards).

330. *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977).

331. See Buxbaum, *supra* note 322, at 1694, 1694 n.101 (“The provision allocated one vote for each twenty shares owned after the first fifty shares, and prohibited a stockholder from voting more than one-quarter of the shares issued and outstanding, unless as proxy for others. As a result, the plaintiff, who was the largest shareholder, had twenty-eight percent of the shares yet only three percent of the voting power.”)

332. DEL. CODE ANN. tit. 8, § 151(a).

and thus was uniform as to shares, and operated unevenly only as to those shareholders crossing certain ownership levels.³³³

The other landmark case, *Williams v. Geier*,³³⁴ directly upheld a proposed tenured voting structure. Existing shares won ten votes per share. Upon their transfer, they would revert to one vote per share, and newly issued shares would also have one vote per share—but all those held thirty-six months would accrue ten votes. The court considered the board's proposal to be an ordinary business judgment entitled to utmost judicial deference.³³⁵

If scholars agree that the case law clearly upholds tenured voting, there is more debate about whether stock exchange listing rules restrict it. Scholars routinely point to the New York Stock Exchange listing rule on voting rights, which by its terms, prevents a listed company from switching to tenured voting.³³⁶

But three qualifications have been made: Professor Belinfanti notes that stock exchange interpretive guidelines could warrant a waiver for a company with rational business concerns about short-termism,³³⁷ Professor Rock views any such impediment to

333. The case is cited in the time weighted voting literature as an analogous structure. See Edelman et al., *supra* note 4, at 999 (“The scaled voting structure in *Providence & Worcester* is analogous to tenure voting, simply substituting the limiting factor of holding duration for holding size.”). Its holding squarely covers one of the features that could be used to define quality voting, as discussed in Section IV.D.

334. *Williams v. Geier*, 671 A.2d 1368 (Del. 1996) (overruling a decision by New York federal district court in *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*, 618 F. Supp. 407 (S.D.N.Y. 1985), which purported to reject the validity of tenured voting under Delaware law).

335. The plan was neither a defensive measure under *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), which required elevated scrutiny for reasonableness as the trial court had held, nor an infringement on the shareholder franchise under *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988), which required enhanced scrutiny as the plaintiffs had urged.

336. E.g., Rock, *Eugenics*, *supra* note 79, at 903 (quoting the NYSE listing requirement to which the NACD has a similar counterpart: “Voting rights of existing shareholders of publicly traded common stock . . . cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time phased voting plans, the adoption of capped voting rights plans, the issuance of super voting stock, or the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer.”).

337. Belinfanti, *supra* note 64, at 834 (quoting the NYSE listed company manual: “[t]he Exchange’s interpretations under [its voting rights policy] will be flexible, recognizing that both the capital markets and the circumstances and needs of listed companies change over time”).

recognized alternative voting regimes as ill-advised,³³⁸ and Professors Berger et al. believe that the reasoning in *Providence* should apply to the interpretation of the NYSE rules to permit tenured voting.³³⁹

As a matter of corporate policy, two corporate law scholars have recognized tenured voting as a valid method of shareholder cultivation for companies seeking a longer-term base. Belinfanti opines: “As a cultivation tool, it rewards stewardship capital on one hand, and potentially discourages . . . flippers and short-term gamblers.”³⁴⁰ Rock stresses incentives: “[I]t provides greater incentives to longer-term shareholders to invest in making those decisions and greater incentive to remain shareholders to enjoy the increased voting rights.”³⁴¹ Rock refrains from opining on whether this would be desirable or not, however, noting downsides.³⁴² On balance, though, Rock favors the flexibility offered:

In an age of empowered shareholders, in which firms should think about selecting and shaping an optimal shareholder base, prohibiting a key design tool is inappropriate. . . . [F]irms and shareholders should at least have the option to experiment with different ways of shaping the shareholder base.³⁴³

338. Rock, *Eugenics*, *supra* note 79, at 903.

339. Berger et al., *supra* note 4, at 319–20 (rule forbids “disparately” reducing voting rights, but switching to a tenured voting is non-disparate because it is equally applicable to all shares held for stated durations). Edelman et al. are not sure and said they are not aware of any company that has done so. Edelman et al., *supra* note 4, at 1002–03 (“The NYSE voting rights policy precludes companies from adopting tenure voting plans for existing shares. . . . [M]ost commentators agree that listing rules allow the adoption of tenure voting at only the IPO stage.”).

340. Belinfanti, *supra* note 64, at 834.

341. Rock, *Eugenics*, *supra* note 79, at 901.

342. Downsides are the “inverse of the upsides,” including cementing insider control despite small stakes. Another is this caution: “[I]f long-term shareholders are typically index funds who, in competing on price, resist portfolio firm-specific investments . . .” Rock, *Eugenics*, *supra* note 79, at 902. This is an important caution about how a voting regime focused on horizon can be impaired by a problem of conviction. It is an example of the importance of combining both horizon and conviction in a single analysis as well as the need to recognize that not all long-term shareholders are “typically index funds.” Many are quality shareholders.

343. *Id.* at 903–04.

2. Research and data

The research that reignited interest in tenured voting began with Professor Dallas, whose 2017 work with Professor Berry investigated its implications for corporate governance and effects on managerial myopia.³⁴⁴ The article's main points were a policy view of tenured voting and an examination of the dozen U.S. companies that have tried it. They considered three rationales for tenured voting: increasing power of long-term shareholders, encouraging longer hold periods, and nudging corporate culture towards a long-term value focus.³⁴⁵

The study found that the plans did not reduce managerial myopia by lengthening shareholder holding periods,³⁴⁶ nor did it affect institutional ownership or increase long-term ownership, which actually decreased. They found that, like dual class, tenured voting increased the wedge between ownership and control, as insiders could sell shares over time while maintaining voting power. The increased agency costs were not offset by a greater long-term focus.³⁴⁷ Despite these findings, the authors encouraged continued experimentation with tenured voting, stressing almost exclusively its implications concerning horizon, rather than conviction.

More recently, Professor Berger and his co-authors proposed tenured voting as a way to address short-termism, presenting it as a better alternative to dual class.³⁴⁸ They approach the prescription principally in terms of time horizon, stressing perceived short-termism from shortening average holding periods and increasing activism.³⁴⁹ They argue that tenured voting creates incentives to hold for long periods, reduces short-term myopia, attracts long-term capital, and promotes a long-term corporate culture.³⁵⁰

Amid the authors' impassioned entreaties focused on time horizon, there is only limited attention to conviction, and none to the quality shareholder. On the subject of conviction, the scholars

344. Dallas & Barry, *supra* note 9, at 551.

345. *Id.* at 570–71.

346. *Id.* at 620–21.

347. *Id.* at 611–12.

348. Berger et al., *supra* note 4, at 297.

349. *Id.* at 298–300.

350. *Id.* at 307–09.

say only that tenured voting should not be expected to attract any additional indexers to a shareholder base. That is true, of course, because indexers do not make investment decisions based on such firm-specific governance features.

Most recently, Professor Edelman and his co-authors were motivated by concerns that tenured voting can entrench management,³⁵¹ so they analyzed its likely effect in a contested board election. Their model recognizes additional tenured voting power in incumbents, less voting power in the hands of an activist new to ownership, and variable voting power among the variety of other shareholders. (The model did not distinguish among varying levels of concentration or diversification.) They made two major findings.

First, when insiders of a company adopting tenured voting own and keep a sizable block—20% to 30%—that proves a formidable deterrent to even their most committed opponents who might seek to acquire voting control. Second, if such insiders instead sold down to a point where majority voting power fell into institutional investor hands, the tenured voting mechanisms no longer protect the insiders' control.

The upshot, for the authors, is to view tenured voting as a reasonable compromise between one-share, one-vote and dual class, in that it grants incumbent inside controls an edge but only if they maintain substantial skin in the game. Given that finding, it would also be interesting to investigate the further effects of granting additional voting power based on conviction—more votes to concentrated than to diversified shareholders. We move to that in Section D; first consider, briefly, current proposals to sterilize the votes of index funds.

351. *Id.* at 297. This concern appears particularly strong in Italy, where critics express concern that the intention to elongate shareholder time horizons can also entrench managerial tenures. Chiara Mosca, *Should Shareholders Be Rewarded for Loyalty? European Experiments on the Wedge Between Tenured Voting and Takeover Law*, 8 MICH. BUS. & ENTREPRENEURIAL L. REV. 245, 245 (2019) (“[T]enured voting rights disappoint their expectations and are rarely used to meet a true need of long termism.”). Such regimes do not increase the level of engagement of passive indexers. See Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, 55 SAN DIEGO L. REV. 803 (2018).

C. Variations: Anti-Indexer

Corporate law scholars have identified numerous concerns about indexers casting shareholder votes, ranging from limited monitoring capabilities to incentives to favor managers, as discussed in Part III. Calls to eliminate or curtail related shareholder voting rights ensue. All focus on indexer passivity – lack of conviction – rather than time horizon.

Professor Lund proposes for index funds to abstain from voting altogether – contrary to current law which requires large institutional investors to cast their ballots.³⁵² The rationale is that indexers, based on the critical evidence summarized in Part III, lack requisite incentives or capacity to become informed about corporate voting. The effect would increase the voting power of quality shareholders as well as all non-indexers, whatever their time horizons or other attributes.³⁵³

Professors Bebchuk and Hirst oppose Lund's proposals for two reasons. First, despite their criticism of indexers outlined in Part III, that does not lead them to think that the voting decisions of other investors are superior. Their main criticism here, however, lumps all non-indexers (and non-managers) together without separately recognizing the quality shareholder cohort.

Instead, they single out "individual retail investors" as lacking requisite incentives to become informed,³⁵⁴ and "active mutual fund managers" as not having shown superior investment in becoming informed compared to indexers.³⁵⁵ Attention to quality shareholders might change this analysis.

A second form of anti-indexer voting measures would require the funds to pass their voting rights through to the beneficial owners of the fund.³⁵⁶ This likewise seeks to remedy the limited incentives and capacity the fund has to cast informed votes.

352. Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018); see also Todd M. Henderson & Dorothy S. Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, WALL STREET J., June 23, 2017, at A15.

353. Lund, *supra* note 352, at 528–30. An alternative would focus on the perceived pro-management bias of index funds and allocate indexers' votes in proportion to the votes of non-management non-indexers. See *id.* at 530–31.

354. Bebchuk & Hirst, *supra* note 3, at 2218 n.227.

355. *Id.* at 2218 n.228.

356. See Caleb N. Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, 79 MD. L. REV. 954 (2020).

Bebchuk and Hirst again fairly thought they could benefit from delineating the shareholder base further. As they stand, the objections are almost entirely concerned with individual fund beneficiaries, when indexers also manage assets for many different kinds of institutions (if not quality shareholders).³⁵⁷

The logical next step after these criticisms—and all three pending debates over shareholder voting regimes—is quality voting, an approach that zeroes in on two behaviors all participants seem to laud: shareholders with a long-term horizon and high level of conviction.

D. Quality Voting: Pro-quality

To recap this Part so far, dual class voting structures are motivated by entrepreneurs averse to shareholder activism or other short-term pressures, though their own economic stakes are not as concentrated; tenured voting is motivated by policy advocates to reduce short-termism; and anti-indexer variations are motivated by policy advocates to negate the arguably ill-informed diversified indexers. The rationale of each scheme is binary—a focus on short- or long-term horizon for dual class and tenured and a focus on relative concentration for the anti-indexer variations.

It is logical to consider conjoining both long-term and concentrated behavior in a voting policy that I will call quality voting. Quality voting increases the power of long-term committed owners—quality shareholders. It refines tenured voting to account not only for duration but conviction.

357. Professor Griffith offers another approach which would compromise based on the type of voting topic in terms of whether funds have a plausible information advantage compared to their customers, distinguishing between, for instance, mergers versus social proposals. See Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983 (2020). While interesting, this proposal faces the definitional challenge of classifying the type of voting topic as well as the same issue of rational apathy of the account holders. I concur with the rationale for such an assertion, which is that funds and many corporate governance experts overestimate their ability to rank governance provisions from good to bad on an abstract basis.

Professors Lund and Griffith co-authored another piece advocating for an even more interesting approach to address conflicts of interests that index funds face. Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151, 1181–86 (2019). They look at conflicts arising from mutual fund structures and suggest the solution of excluding their vote in votes requiring a minimum level of disinterested shares to carry.

Participants in the debate will have varying responses to a proposal to increase voting power of both long-term and concentrated shares. But while many skeptics may remain skeptics, some may see things differently: proponents of one or the other approach may agree or disagree with quality voting; those who support both may have already come to the same conclusion as this Article does without having yet contributed it to the literature.

To better explain the specifics of quality voting, this Article compares it to other regimes discussed above, namely, dual class voting and tenured voting.

1. Comparing regimes

Unlike dual class voting, quality voting remains democratic. It does not inevitably or irremovably cement control in designated hands but operates as a fluid advantage that fluctuates as investors rebalance their portfolios over time in varying weights.

As with tenured voting, quality voting is almost certainly permitted under corporate law—in fact, one of the two landmark cases in this area, *Providence*, addressed a plan more akin to quality voting than to tenured voting (though it was the inverse, capping voting rights of concentrated shares, whereas quality voting would multiply voting rights of concentrated shares). The case under New York Stock Exchange rules remains equivocal but is stronger than for tenured voting, since the text of the rule expressly refers to “time phased voting plans.”³⁵⁸

Also, as with tenured voting, quality voting would be a valuable shareholder cultivation mechanism. It would probably be of greater effect for the discrete group of quality shareholders. It would pose less risk than tenured voting of entrenching managers after they decrease ownership because concentration levels would still be counted. It would pose none of the downside risk of increasing the voting power of ill-equipped indexers.

As with dual class and tenured voting, the exact terms could be tailored to suit.³⁵⁹ Reliable references can draw upon the selection criteria used by researchers in identifying the quality shareholder

358. See *supra* text accompanying note 336 (quoting the rule).

359. See *supra* text accompanying notes 312–15 (noting how dual class can vary voting rights with the subject matter of the vote, among other ways); see *supra* text accompanying note 319 (noting how tenured voting can vary voting power according to duration, multiple, and subject matter of the vote).

cohort, all of which is publicly filed with the SEC for most institutional investors and relatively easy for reasonable investors to determine from their regular records.

As to conviction, examples of such inputs are percentage of a shareholder's portfolio in the stock, average stock percentage in the shareholder's portfolio, and number of other stocks in the portfolio.³⁶⁰ Companies could access the relevant databases of scholars who maintain ongoing records of shareholder quality.³⁶¹

To illustrate, consider a simple model comparing one-share, one-vote first with tenured voting, and then with quality voting. Imagine a simple shareholder base, where the period of ownership of outstanding shares is about equally distributed among older and newer shareholders and those in between—such as one-third owned for less than one year, more than three years, and in between.

With ninety-nine shares outstanding, each cohort controls thirty-three votes. No single cohort can command the outcome of any vote. But if time-weighted voting added three votes to each share held longer than three years, then that cohort would have ninety-nine votes, the others would still have thirty-three each and a combined sixty-six votes. The seasoned cohort would then dictate the outcome of every vote. But it is not obvious that such seasoning translates into proportionally greater wisdom for a company.

Time-weighted Voting Power		
Duration & Multiple	Normal Votes	Time-weighted Votes
< 1 year = 1x	33	1x = 33
1–3 years = 1x	33	1x = 33
> 3 years = 3x	33	3x = 99

That invites consideration of quality voting. To take one of the potential proxies for conviction, suppose these are shares representing a substantial portion of a shareholder's portfolio, measured as a percentage of the shareholder's total public company equity portfolio. For example, two votes per share could

360. See *supra* text accompanying notes 57–59 (summarizing the criteria used in Professor Bushee's research).

361. See *supra* text accompanying notes 61–62 (summarizing the methods and data of both Professor Cremers and Borochin).

be granted to shareholders allocating between one percent and five percent of their portfolio to the company and three votes per share to those allocating more than five percent. If tenured voting implicitly assumes that longer-held shares cast higher-quality votes, the hypothesis follows that shares owned by those with greater exposure will also have such merit.

To adjust the previous illustration, suppose portfolio concentration is randomly distributed across durations. Combining duration with concentration, the short term unconcentrated cohort would remain entitled to thirty-three votes while the longest holding and most concentrated would enjoy 199 votes. Updating the previous table that showed the effects of duration in tenured voting, this table adds the effects of concentration.

Quality Voting Power		
	Duration Multiple	Concentration Multiple
None	< 1 year = no multiple	< 1% x = no multiple
Some	1-3 years = 2x	1-5% = 2x
Substantial	> 3 years = 3x	> 5% = 3x

The outcome of any vote would be determined by a fluid combination of shareholders boasting relatively longer durations and higher concentrations. To complete the illustration, the next table applies the multiples to the previous example of a company with ninety-nine shares outstanding, with thirty-three each held for varying durations and concentrations.

Votes Given Combinations of Concentration and Duration			
	Concentration		
Duration	< 1% = no multiple	1-5% = 2x	> 5% = 3x
< 1 year = no multiple	33	66	99
1-3 years = 2x	66	132	165
> 3 years = 3x	99	165	198

The shaded area reflects the number of votes commanded given concentration and duration levels.

(This example presents the multiples in the proportion of 1-2-3. That is a high magnitude of change in multiples, which may be too

large for comfort in an experimental stage. More modest multiples could be set, such as 1, 1.33, and 1.66; or even 1, 1.2, and 1.4.)

2. Pros and cons

Quality voting can be adopted by charter amendment under state corporation law along with an application to the stock exchange for a waiver of any restrictions on alternative voting regimes. In this legal sense, it is akin to dual class or tenured voting—all of which are easier than the variations of anti-indexer regimes, which would require legal changes and related political support.

As with dual class and tenured voting, quality voting enables each company to design the details and tailor the arrangements to suit in a joint exercise involving solely board and shareholder approval. Each company must weigh the following costs and benefits of adoption.

Administrative burdens may be high. While the five-year-old experience in France suggests that administration is feasible, the U.S. system has some different features. One problem is how most U.S. equity is held in the names of depository nominees rather than ultimate owners, complicating the task of tracking ownership concentration.³⁶² Recordkeeping and calculations can be complex, especially for large institutions investing through multiple funds, including those with diverse mixes of debt, equity, and other securities.³⁶³

362. See Edelman, *supra* note 4, at 297 (drawing on David C. Donald, *Heart of Darkness: The Problem at the Core of the U.S. Proxy System and Its Solution*, 6 VA. L. & BUS. REV. 41, 50 (2011)). In brief, before the 1970s, share ownership records were maintained manually in a traditional paper recording system maintained by individual brokerage firms. Trading volume proved too much for such a system, however, creating backlogs in updating transfer records. To meet this challenge, the industry developed a computerized system maintained in a central depository, called the Depository Trust Company (DTC). Today, the vast majority of stock is held through DTC, with stock formally owned by its nominee, Cede & Co., and held in the name of the brokerage firm that arranged the purchase (called “street name” on behalf of the “beneficial” owner).

363. Corporations must maintain stockholder lists to determine associated rights, on voting and other matters. *E.g.*, DEL. CODE ANN. tit. 8, § 219(a) (2020). In the process, companies contact DTC to enumerate the breakdown of brokers holding shares through Cede. The Cede breakdown can be cumbersome, can involve numerous interactions between the company and DTC, and is error-prone. Edelman et al., *supra* note 4, at 1004. Such challenges and risks multiply for companies with peculiar voting rules, such as tenured voting, as this requires additional information such as duration of holdings.

In fact, companies that rescinded tenured voting often cited administrative complexity as a reason.³⁶⁴ Administering commitment-weighted voting would pose additional cost, particularly in recordkeeping and verification. For example, duration is a fixed measure of time, whereas concentration can vary substantially over time.

On the other hand, those companies that maintain tenured voting invoked common solutions. For example, one common solution to the challenge of street name ownership was to deem street name stock as low vote.³⁶⁵ Such an approach could be modified by making that a presumption that each shareholder would have the right to challenge.

Such a simple approach can be implemented immediately for all shareholders, including individuals, by shifting the burden of disclosure to the shareholder: any shareholder wishing to exercise quality shares would be required to submit qualifying evidence to the corporate secretary accordingly. The corporate secretary can create uniform rules describing what evidence qualifies and standardized procedures to verify it.

Moreover, holdings are readily observable from public filings for institutional investors and can be verified by reference to disclosure that is legally required and subject to federal anti-fraud rules. For these shareholders, enhanced voting power could be made optional and subject to the company's confirmation of verified shareholder applications.

Just as technology helped solve the paper crisis, technology is likely again to solve the street name problem, including the administration of special voting rules. Advances in tracking technology, particularly digital ledgers based on blockchain tools, promise to make administration of quality voting manageable. In 2017, Delaware corporate law was amended to permit companies to use blockchain (or distributed ledgering) to maintain their shareholder lists.³⁶⁶ These enable digital records showing every transaction involving every share of stock, with precise details of

364. See Edelman et al., *supra* note 4, at 1005 n.89 (quoting Church & Dwight Co., Inc., Proxy Statement (Form PRE 14A), at 27 (Mar. 21, 2003)).

365. See Dallas & Barry, *supra* note 9, at 602.

366. DEL. CODE ANN. tit. 8, § 219(c).

beneficial rather than street ownership as well as duration and other data.³⁶⁷

In any event, such costs must be compared to the gains. In general, gains can be approximated by reference to some of the common contexts where suboptimal voting has been recognized. These would include many of the instances where indexers have conflicts of interest as well as the legal contexts in which courts have recognized transient shareholder appetites to be problematic.

Under quality voting, finally, activist shareholders may often gain enhanced power when they hold meaningful stakes for long periods. Voting power could also increase during the course of multi-year campaigns, as more votes accrue over time. Both points may attract activists, but while managers may see some associated costs, they will be activists more patient and focused than other shareholders, producing comparative gains.

Assuming administrative costs are generally similar for most companies and nontrivial, the ultimate issue is how given companies weigh the advantages of attracting a higher density of quality shareholders. To recap such advantages from Section I.E, first, quality shareholders offset all the disadvantages of other cohorts by deterring overzealous activism, balancing short-term pressures, and contributing informed decision-makers that indexers rarely offer. Second, quality shareholders offer the prospect of outstanding director nominees, the benefit of unpaid consulting advice, and connections to other strategic business opportunities. Third, quality shareholders promote more rational stock pricing, being more interested in a close connection between stock price and business value than a high stock price for its own sake.

Companies will almost certainly value such advantages differently, and the relative magnitude of these benefits will vary across companies. For example, companies enjoying other sources of insulation from activist pressure or indifferent to short term stock market pressures may care less about quality shareholders than those facing such pressures. For the latter cohort, the benefits of quality shareholders may well dwarf the administrative costs. Accordingly, while this Article's analysis does not warrant—

367. See Edelman et al., *supra* note 4, at 1006 (explaining that these tools would be a “great advantage” for tenure voting to “make it easier for companies to trace the identity of their shareholders and therefore more accurately assign high and low voting rights”).

and the Article does not prescribe—general adoption of quality voting, the argument readily encourages enthusiastic consideration by the cohort for whom more quality shareholders would likely add net value.

CONCLUSION

Shareholders that buy large stakes and hold for long periods offer numerous advantages to the companies in which they invest. Companies wishing to attract more of them would do well to adopt policies and practices that entice them. An obvious method would grant them superior voting rights to short-term and diversified shareholders. This Article reaches this solution by originally combining the horizon debate (shorter versus longer investment horizons) with the conviction debate (lower versus higher investment concentration) to better incentivize quality shareholders.

Why have quality shareholders, including Warren Buffett, been neglected in the corporate law scholarship on horizon, conviction, and shareholder voting? One possibility is the familiar difference between theory and practice. Scholars work with theories that may or may not map onto actual behaviors. A tension sometimes resides between academic and practical perspectives in scholarly work.³⁶⁸

The last generation of corporate law and finance scholarship, for instance, saw a disconnect between modern finance theory and Buffett.³⁶⁹ Theorists developed the efficient capital market hypothesis, capital asset pricing model, and modern portfolio theory as a construct that contradicted most everything Buffett thought and did—the theorists even suggested that he could not have done what he did.³⁷⁰ The theories being developed in today's corporate law debates recall a flavor of that gap, where the light shines on short-term activists and long-term indexers but none at all on the long-term, concentrated, quality shareholder.

As Professor Bebchuk and his colleagues have noted in one of their many major contributions to the conviction debate, they are

368. See, e.g., Eric A. Posner, *Standards, Rules, and Social Norms*, 21 HARV. J.L. & PUB. POL'Y 101, 106 (1997) (exploring a theoretical model that has little practical use).

369. See Lowenstein, *supra* note 24, at 934.

370. *Id.* (reviewing finance theory of the era, during which theorists simply ignored Buffett's record, wished it away, or dismissed him as an outlier). As one scholar wrote, "[I]t is odd, is it not, that not one EMT theorist has seen fit to study Buffett? . . . The response to Buffett has been either a deafening silence or a clumsy attempt to avoid the engagement." *Id.*

putting forward a theory of institutional investor incentives that predicts impoverished decision making while acknowledging that actual decision making may be superior to the model.³⁷¹ Other scholars in this debate likewise theorize and model without necessarily accounting for all relevant incentives of all the diverse actors, especially quality shareholders.

“Well, it may be all right in practice, but it will never work in theory,” Buffett has famously quipped.³⁷² Quality shareholding works in practice and requires only slight adjustment to work in theory. Both theory and practice will be richer when horizon and conviction are combined for study and the quality shareholder’s role is explored. This Article lights the way.

371. Bebchuk et al., *supra* note 241, at 90 (“We recognize that well-meaning investment managers of index funds and active mutual funds may sometimes make stewardship decisions that are superior to those suggested purely by their incentive calculus. Our focus, however, is on understanding the structural incentive problems that should be recognized in assessing the current governance landscape.”).

372. See Katherine Florey, *Big Conflicts Little Conflicts*, 47 ARIZ. STATE L.J. 683, 685 (2015) (quoting Buffett’s “famous quip”).

