

**ON THE ROLE AND REGULATION OF PRIVATE NEGOTIATIONS IN
GOVERNANCE**

*Joseph W. Yockey*¹

INTRODUCTION

Private negotiations between companies and shareholders play a significant role in corporate governance. An increasing number of shareholders are demonstrating a preference for negotiations over such traditional forms of activism as shareholder proposals, proxy contests, and litigation.² In recent years, for example, shareholders at some of the largest public companies in the United States have used negotiations with management to effectuate changes in firm policy that include the disbandment of board committees and the modification of executive compensation plans. These and similar results have led the U.S. Securities and Exchange Commission (SEC), the U.S. Department of Labor, the National Association of Corporate Directors, and other groups to

¹ Visiting Assistant Professor and Academic Fellow, University of Illinois College of Law. My thanks go to Vic Fleischer, Bob Lawless, Andy Leipold, Larry Ribstein, Janelle Sharpe, Bruce Smith, Larry Solum, Charles Tabb, Suja Thomas, and Amy Tomaszewski, as well as participants in the 2009 Annual Meeting of the Law and Society Association and the 2009 Big Ten Aspiring Scholars Conference. Finally, I would like to thank the organizers of the Illinois Academic Fellowship Program for their support.

² See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1042 (2007); Joann S. Lublin, *New Breed of Directors Reaches Out to Shareholders*, WALL ST. J., July 21, 2008, at B4; Shannon Pettypiece, *Pfizer Will Start Meetings With Largest Investors*, BLOOMBERG, June 28, 2007; Stephen Dean, *Board-Shareholder Dialogue: Why They're Talking*, RISKMETRICS GROUP (Feb. 2009) (on file with author); Stephen Davis, *Talking Governance: Board-Shareowner Communications on Executive Compensation*, MILLSTEIN CENTER FOR CORPORATE GOVERNANCE, YALE SCHOOL OF MANAGEMENT (2008) (on file with author); Stuart L. Gillian & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, J. APP. FIN. 4, 10 (Fall/Winter 2003); Martin Lipton, Steven A. Rosenblum and Karessa Cain, *Some Thoughts for Boards of Directors in 2009*, Client Memorandum, Wachtell Lipton, Rosen & Katz (Dec. 8, 2009) (on file with author).

all speak out in favor of more frequent and robust negotiations between boards and shareholders.³

The fact that board-shareholder negotiations have become a viable and effective form of corporate interaction is due in large part to a shift in the governance landscape. For many years, shareholders were thought to be essentially powerless and passive within firms. However, this view is rapidly being eroded as part of a larger movement toward giving shareholders greater voice and influence.⁴ Legal and economic developments – such as the emergence of institutional investors, the trend toward majority voting, and reforms to the proxy system – now arguably make it easier than ever before for shareholders to remove managers and trigger other governance changes.⁵ These developments in turn provide investors with newfound sources of leverage to bring boards to the negotiating table.

Despite the critical importance of private negotiations to a full understanding of corporate governance issues, the legal literature has spared little time to scrutinizing them.⁶ The present Article addresses this oversight by analyzing the governance and regulatory implications that arise when institutional investors and firms negotiate behind the scenes. This analysis demonstrates that negotiations are effective and provide several unique benefits that

³ See Gillian & Starks, *supra* note 2 at 9-10; National Association of Corporate Directors, *Framework and Tools for Improving Board-Shareowner Communications* (2004); Dealbook, “S.E.C. Commissioner Backs ‘Say on Pay’,” Feb. 19, 2009, available at <http://dealbook.blogs.nytimes.com/2009/02/19/sec-commissioner-backs-say-on-pay/>; Remarks of SEC Commissioner Elisse B. Walter, “Corporate Governance – A Master Class 2009,” PLI, Feb. 18, 2009; Remarks of SEC Commissioner Luis A. Aguilar at “The SEC Speaks in 2009,” Washington, D.C. (Feb. 6, 2009) (on file with author).

⁴ See Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008).

⁵ See *id.*

⁶ See, e.g., Robert W. Hamilton, *Corporate Governance in America 1950-2000: Major Changes But Uncertain Benefits*, 25 J. CORP. L. 349, 356-57 (2000); Susan J. Stabile, *Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool to Focus Reform*, 35 WAKE FOREST L. REV. 153, 196-97 (2000); Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 473-74 (2008); Randall S. Thomas, *The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation*, 61 VAND. L. REV. 299, 302-03 (2008). But see Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism for Corporate Governance*, 18 YALE J. REG. 174 (2001).

will often make them a more desirable method for resolving intra-firm differences than traditional forms of corporate communication. In this regard, negotiations add value by filling a governance gap. Shareholders find that negotiations lead to greater transparency and can be a more cost-effective and less confrontational way to push for changes within firms when compared to proxy contests or other forms of activism.⁷ For their part, many boards find that negotiations promote investor trust and goodwill, translate into fewer shareholder proposals and proxy solicitation campaigns, and preempt shareholder litigation.⁸

The Article further contends, however, that current restrictions on corporate speech – namely the SEC’s Regulation FD – must be reassessed in order for negotiations to fully realize their potential as an efficient governance device. Regulation FD prohibits a board from selectively disclosing material information to shareholders if it is unwilling to simultaneously disclose the same information to the public.⁹ Yet, for negotiations with activist institutions to be successful, disclosure of inside company information will often be required. If a company is unwilling or unable to disclose such information to the public, which it may be for any number of valid business reasons, Regulation FD stands as a substantial obstacle to productive negotiations. This result is directly at odds with many of the SEC’s own stated policy positions on the need for greater transparency and communications within firms.¹⁰ To resolve this tension, additional regulatory

⁷ Willard T. Carleton, James M. Nelson & Michael S. Weisbach, *The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF*, 53 J. FIN. 1335 (1998); Marco Becht et al., *Returns to Shareholder Activism*, REV. FIN. STUD. (forthcoming 2009); Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 346-54 (2008).

⁸ Martin Lipton, Steven A. Rosenblum & Karessa L. Cain, Client Memorandum, *Some Thoughts for Boards of Directors in 2009*, Wachtell, Lipton, Rosen & Katz (Dec. 8, 2008); Davis, *supra* note 2.

⁹ 17 C.F.R. § 243.101(b).

¹⁰ See, e.g., Dealbook, “S.E.C. Commissioner Backs ‘Say on Pay’,” Feb. 19, 2009, available at <http://dealbook.blogs.nytimes.com/2009/02/19/sec-commissioner-backs-say-on-pay/>; Remarks of SEC Commissioner Elisse B. Walter, “Corporate Governance – A Master Class 2009,” PLI, Feb. 18, 2009; Remarks of SEC Commissioner Luis A. Aguilar at “The SEC Speaks in 2009,” Washington, D.C. (Feb. 6, 2009) (on file with author).

intervention may be required to ensure that negotiations remain a useful and effective form of governance activity.

Finally, there is particular urgency to explore the largely underappreciated governance implications of negotiations as scholars, regulators, and policymakers continue to propose corporate law reforms in response to recent economic events. Several regulatory reforms to emerge from the global financial crisis have already generated increasing levels of private negotiations between firms and shareholders.¹¹

Part I introduces the Article's analytical framework by providing background on the legal and economic developments that allow for board-shareholder negotiations to play a meaningful role in governance activities. Part II examines the effectiveness of private negotiations in leading to changes in firm policy or strategy. This Part shows how the corporate law continues to evolve in ways that provide institutional investors with greater levels of power, thereby enabling them to rely on negotiations as an increasingly effective form of activism. Developments of particular emphasis include majority voting, the elimination of broker voting, and the significant influence of activist hedge funds. Part III describes the unique benefits that accrue to investors and boards through the use of negotiations. Part IV analyzes the impact of Regulation FD on board-shareholder dialogue. Part V illustrates the promise of negotiations in corporate governance by focusing on a specific test case: the rise of "say on pay" shareholder advisory votes. These votes allow shareholders to democratically express their approval or disapproval of the executive compensation policies and packages at their firms.¹² Though still relatively new in the United States, "say on pay" votes have been required by law at firms in the United Kingdom since 2003.¹³ The British experience with "say on pay" has resulted in a dramatic increase in the level of private negotiations between boards and institutional investors, providing both parties with many of the benefits described in this Article.¹⁴ As "say on pay"

¹¹ See Marketwatch, *SEC OK's Proposal to Give Investors More Say on TARP Pay*, July 1, 2009.

¹² See *infra* text accompanying notes 286-317.

¹³ See *infra* text accompanying notes 286-317.

¹⁴ See *infra* text accompanying notes 286-317.

continues to gain in popularity among American firms – with some now legally bound to provide such votes to their shareholders as part of the American Recovery and Reinvestment Act of 2009 – this evidence suggests that negotiations will become an even more influential form of governance activity in United States in the years to come.

I. NEGOTIATIONS IN GOVERNANCE: BACKGROUND AND
PRELIMINARY OBSERVATIONS

Negotiations between boards and shareholders – particularly institutional investors – have long been a part of corporate governance activities. Nearly twenty years ago, mutual funds such as Fidelity first revealed that they frequently hold private talks with the management of portfolio companies as a way to avoid public “brawling” over governance and strategy issues.¹⁵ Around the same time, Exxon Corporation disclosed that it had engaged in private discussions with a group of public pension funds to address environmental concerns in the wake of the Exxon Valdez oil spill near Alaska.¹⁶ These meetings were the catalyst for Exxon’s decision to appoint an environmentalist to its board.¹⁷ The private engagement between boards and shareholders even received the attention of influential corporate attorney Marty Lipton, who, with Professor Lorsch of the Harvard Business School, wrote in 1992 to urge U.S. boards to hold annual, informal meetings with their largest institutional investors.¹⁸

As the examples of Fidelity and Exxon suggest, many of the early instances of private negotiations between boards and shareholders were initiated by mutual and pension funds.¹⁹ Public pension funds, including CalPERS and several New York state pension funds, as well as TIAA-CREF continue to be particularly active in using private negotiations to encourage boards to make governance changes voluntarily.²⁰ Though they often vary slightly in their specific approaches, these institutions typically follow

¹⁵ Allen R. Myerson, *The New Activism at Fidelity*, N.Y. TIMES, Aug. 8, 1993.

¹⁶ Matthew L. Wald, *Exxon Head Seeks Environmentalist to Serve on Board*, N.Y. TIMES, May 12, 1989.

¹⁷ *Id.*

¹⁸ Martin Lipton & Jay Lorsch, GLOBAL PROXY WATCH, Vol. XI No. 42 (1992).

¹⁹ See Kahan & Rock, *supra* note 2.

²⁰ See *id.*

three steps when they seek to engage a company through negotiations. First, the institution must apply its internal evaluation criteria to the firm or firms it is thinking of targeting in order to decide whether negotiations are in its best interests and likely to succeed.²¹ Some institutions look solely at governance issues at the targeted firm, whereas others look primarily at performance benchmarks (or a combination of governance and performance).²² Next, the institution will usually make informal overtures to the target company in order to begin a dialogue related to its concerns.²³ This step is commonly referred to as “jawboning,” and may begin with a simple letter or phone call to a company director, executive, or investor relations officer.²⁴

At or around the same time, institutions will almost always submit a formal shareholder proposal on the issues they seek to address during the jawboning process.²⁵ Such proposals are filed under SEC Rule 14a-8 and are limited to a description that is no longer than 500 words.²⁶ Under the corporate law in most states, shareholder proposals that ultimately reach a shareholder vote and gain majority approval are nonbinding on the board if they do not relate to a proper subject for shareholder action.²⁷ However, the submission of a proposal at an early stage in the negotiations is often used to alert the target company of the investor’s seriousness.

The typical engagement process described above is only possible if an institution has sufficient leverage over the target firm to open a line of communication. That is, methods of informal influence, like private negotiations, will only be effective if there are formal enforcement mechanisms to back them up.²⁸ Why might an actual or threatened shareholder proposal prompt a board to open negotiations with an institutional investor and, in many cases, voluntarily adopt the requested change? Several

²¹ See Carleton, Nelson & Weisbach, *supra* note 7; Becht et al., *supra* note 7.

²² See Carleton, Nelson & Weisbach, *supra* note 7; Becht et al., *supra* note 7.

²³ See Carleton, Nelson & Weisbach, *supra* note 7; Becht et al., *supra* note 7; Robert W. Hamilton, *Corporate Governance in America 1950-2000: Major Changes But Uncertain Benefits*, 25 J. CORP. L. 349, 356-57 (2000).

²⁴ Hamilton, *supra* note 23 at 356-57.

²⁵ See Carleton, Nelson & Weisbach, *supra* note 7.

²⁶ See *id.*

²⁷ See 17 C.F.R. § 240.14a-8(i)(1).

²⁸ Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 524 (1990).

developments in corporate law and governance help to answer this question.

a. *Traditional Views on Governance and Shareholder Power.*

Since originally described by Berle and Means, the separation of ownership and control that characterizes the modern public corporation contemplates a governance arrangement whereby shareholders exercise virtually no control over the operations and objectives of the firms in which they have invested.²⁹ Instead, control is vested in the board of directors and those executives and managers selected by the board to oversee day-to-day operations.³⁰

Given this framework, corporate law scholars have traditionally sought to design governance arrangements that reduce the agency costs associated with the division of ownership and control by aligning the interests of investors with the incentives of managers.³¹ In the most basic form, shareholders, as owners, elect a board of directors bound by fiduciary duties to oversee the firm on their behalf. However, directors and officers selected by directors might shirk, steal, or otherwise act in ways that are contrary to the interests of shareholders.³² They might also act to satisfy their own self-interest at shareholder expense by doing things like creating provisions that will protect them from takeover risk, directing corporate business to friends or family, or stacking boards with directors who give deference to the whims of management.³³

²⁹ Adolph A. Berle & Gardiner C. Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 78 (1932).

³⁰ Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

³¹ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Roberta Romano, *Corporate Law and Corporate Governance*, 5 INDUS. & CORP. CHANGE 277 (1996); Frederick Tung, *Leverage in the Boardroom: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. ___ (forthcoming 2009).

³² Tung, *supra* note 31.

³³ *Id.*

To be sure, corporate law generally provides shareholders with a limited set of tools for checking potential abuses by management. For example, shareholders may (a) vote to elect directors; (b) vote to approve major corporate transactions, such as mergers; (c) use the proxy process to offer proposals or resolutions for a shareholder vote; (d) propose bylaw amendments; and/or (e) sue to enforce the fiduciary duties owed to them by management.³⁴

However, as has been well-documented by others, the monitoring devices traditionally afforded to shareholders render individual investors relatively powerless to enact meaningful changes in managerial behavior.³⁵ For one, when shareholders are widely dispersed and own only a small percentage of shares in a company, it simply does not make economic sense for individuals to spend time, money, and energy trying to invoke corporate change.³⁶ There is no incentive for any one stockholder to monitor management when she would bear all the costs while all other shareholders free-ride on the benefits.³⁷ In the words of Berle and Means, “[w]hen the largest single [stockholder] interest amounts to but a fraction of one percent – the case in several of the largest American corporation – no stockholder is in the position through his holdings alone to place important pressure on management.”³⁸ Thus, the reality of widely dispersed share ownership leads to rational apathy by individual shareholders.

Furthermore, U.S. corporate law poses several obstacles to shareholders who wish to use the corporate election and proxy process to promote change in governance. The law generally allows incumbent directors to use corporate funds to solicit shareholder proxy votes in support of their positions.³⁹ By

³⁴ See Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. Rev. 561, 569 (2006); Tung, *supra* note 31.

³⁵ Anabtawi & Stout, *supra* note 4; Black, *supra* note 28.

³⁶ See ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 76 (1932) (“[T]he normal apathy of the small stockholder is such that he will either fail to return his proxy vote, or will sign on the dotted line, returning his proxy to the . . . corporation.”).

³⁷ See Robert C. Clark, *CORPORATE LAW* (1986); Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L. J. 1227, 1231 (2008).

³⁸ BERLE & MEANS, *supra* note 36 at 76.

³⁹ See *id.* at 76; Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 686-89 (2007).

contrast, any individual shareholders who hope to mount a challenge must use their own personal funds in any solicitation efforts.⁴⁰ They must further distribute a separate proxy statement, describing only their candidate, and must successfully campaign for more votes than the slate of directors proposed by the incumbent management and described on the company's annual proxy statement.⁴¹ This is an extremely expensive process, both in terms of time commitments and fiscal outlays.⁴² Once the costs of launching a proxy solicitation campaign are weighed against the chances of ultimate success, many shareholder initiatives effectively die before they are undertaken.⁴³ The end result is that very few board elections are actually contested.⁴⁴

Given the practical constraints on shareholder intervention and influence, it was generally thought that it made the most economic sense for dissatisfied shareholders to voice their opinions through their feet.⁴⁵ That is, under the so-called "Wall Street Rule," shareholders who disagreed with company decisions may be best served by simply divesting their shares and moving on to other investment opportunities rather than engaging in seemingly fruitless attempts to convince the company to change its ways through the corporate election process.⁴⁶ This state of affairs has led many scholars to explore alternative ways to address the agency cost problem of separating ownership and control within firms. For example, some focus on board composition and structure,⁴⁷ forms and manner of executive compensation,⁴⁸ the

⁴⁰ See BERLE & MEANS, *supra* note 36 at 76; Briggs, *supra* note 39 at 686-89.

⁴¹ See BERLE & MEANS, *supra* note 36 at 76; Briggs, *supra* note 39 at 686-89.

⁴² Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007).

⁴³ *Id.*

⁴⁴ *Id.* (describing how from 1996-2004, incumbents faced rival director nominees only 108 times, or about 12 companies per year. Companies with market value in excess of \$200 million had 17 contested elections, two of which were successful).

⁴⁵ Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 130 (2009).

⁴⁶ *Id.*; Black, *supra* note 28; Edward Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445, 572-73 (1990).

⁴⁷ See Sanjai Bhagat & Bernard Black, *The Uncertain Relation Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999); April Klein, *Firm Performance and Board Committee Structure*, 41 J. L. ECON. 275, 300 (1998).

market for corporate control,⁴⁹ the separation of economic rights from voting rights within firms,⁵⁰ the use of independent directors,⁵¹ the proper understanding of fiduciary duties,⁵² and the role of private lenders.⁵³

Arguably, the one alternative to receive the most attention in the legal literature concerns the roles and behavior of institutional investors.⁵⁴ As indicated in the Berle & Means' quotation from 1932 above, the traditional characterization of shareholders as essentially powerless emerged at a time when most shareholders were individuals who held only miniscule percentages of the shares in public companies. This view no longer reflects the current market. Within the last twenty years or so, the historical profile of shareholders has changed dramatically with the emergence of institutional investors – namely mutual, pension, and hedge funds – that hold large blocks of stock in particular companies.⁵⁵ As a result, scholars and policymakers have found a class of shareholders that has options besides simply divesting shares and exiting whenever disagreements with management arise. Institutions can now use their ownership of

⁴⁸ See, e.g., LUCIAN A. BEBCHUK & JESSE M. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004); Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453 (2008).

⁴⁹ See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

⁵⁰ Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006); Henry T. C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 342 (2007); Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PENN. L. REV. 625 (2008).

⁵¹ See, e.g., Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L. J. 797, 797-98 (2001).

⁵² See, e.g., Stephen M. Bainbridge, Star Lopez, & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559 (2008); Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833 (2007); Kelli A. Alces, *Debunking The Corporate Fiduciary Duty Myth*, 35 J. CORP. L. __ (forthcoming 2009).

⁵³ Tung, *supra* note 31.

⁵⁴ See Anabtawi & Stout, *supra* note 4; Lynn Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789; Black, *supra* note 28; Rock, *supra* note 46; Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. REG. 174 (2001).

⁵⁵ See Anabtawi & Stout, *supra* note 4.

large holdings to work for changes within firms through corporate elections and other means.⁵⁶

b. *The Emergence of Institutional Investors.*

Beginning in the early 1990s, several scholars began to explore the possibility that institutional investors could be able to solve the rationally apathy and practical difficulties that result from widely diffused share ownership.⁵⁷ The basic thought was that institutional investors, which typically hold much larger percentages of stock than individual investors, could use their voting power, expertise, and resources to ensure that the incentives of directors and managers are aligned with the interests of the company's shareholders.⁵⁸

The first institutions to receive attention were mutual and pension funds. These entities aggregate the savings of thousands of individuals into large portfolios that purchase stock in a broad range of public companies.⁵⁹ They have the ability to use their size and scope to buy large blocks of stock within the companies of their choosing, and, by most accounts, now own nearly 75% of all outstanding shares in the U.S. equities market.⁶⁰ Through their large holdings, institutional investors are thought to be able to overcome the rational apathy problem presented by diffuse, individual shareholders.⁶¹ As Professor Black explained in his seminal article on the subject, "the model of public companies as owned by thousands of anonymous shareholders simply isn't true. There are a limited number of large shareholders and they know each other."⁶²

But size and resources only go so far in explaining why institutions are well poised to influence corporate governance and strategy. Parallel with the increasing holdings of institutions, corporate law has evolved to give institutions more tools by which

⁵⁶ *See id.*

⁵⁷ *See, e.g.,* Black, *supra* note 28; Rock, *supra* note 46; Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811 (1992).

⁵⁸ Black, *supra* note 28; Rock, *supra* note 46.

⁵⁹ Anabtawi & Stout, *supra* note 4.

⁶⁰ Anabtawi & Stout, *supra* note 4; *see* Rock, *supra* note 46.

⁶¹ *See* Rock, *supra* note 46.

⁶² Black, *supra* note 28.

they can exercise their influence over firms. A particularly significant development came in 1992 when the SEC amended the federal proxy regulations to allow large shareholders to exercise their voting power more effectively.⁶³ Prior to this amendment, the term “proxy solicitation” was defined to include any communication “reasonably calculated” to influence the vote of another shareholder.⁶⁴ This definition made it practically impossible for one shareholder to communicate with other shareholders unless it was willing to comply with the SEC’s burdensome disclosure requirements for all proxy solicitations.⁶⁵ To overcome this obstacle, the 1992 amendments carved out from the definition of “proxy solicitation” shareholder communications that are not accompanied by a formal proxy solicitation.⁶⁶

These amendments also gave additional guidance concerning public statements by shareholders, indicating that items like press releases, internet communications, and advertisements were also outside of the scope of “proxy solicitations.”⁶⁷ Such developments within the proxy structure made it feasible for institutional investors to discuss their views on governance and strategy with each other.⁶⁸ Based on the decisions reached during these discussions, they would then be able to combine their holdings and vote a larger percentage of total shares in a joint-effort.⁶⁹

Coordination among institutions has been further aided by the rise in popularity of shareholder advisory services. These firms, best exemplified by the activities of RiskMetrics Group (formerly Institutional Shareholder Services or “ISS”), provide mutual and pension funds with advice and recommendations on how they should vote the proxies held in their portfolios.⁷⁰ Such recommendations often concern director elections and antitakeover

⁶³ Briggs, *supra* note 39.

⁶⁴ 17 C.F.R. § 240.14a-1(1).

⁶⁵ Briggs, *supra* note 39.

⁶⁶ 17 C.F.R. § 240.14a-1(1).

⁶⁷ *Id.*

⁶⁸ Briggs, *supra* note 39.

⁶⁹ *Id.*; Anabtawi & Stout, *supra* note 4.

⁷⁰ See homepage for RiskMetrics Group, available at <http://www.riskmetrics.com/history>.

devices, among other governance matters.⁷¹ Similar to the way in which the 1992 amendments to the federal proxy regulations enabled institutions to form large voting blocks, when shareholder advisory services like RiskMetrics coordinate the voting activity of a large group of institutions, the effect is essentially the formation of substantial voting bloc controlled for all intents and purposes by the advisory service itself via its recommendations.⁷² In the words of Professors Stout and Anabtawi, “the widely dispersed individual shareholders of Berle & Means’ day, who routinely voted with corporate management, have been replaced to a great extent by a single and far more independent-minded ‘voter’ – [RiskMetrics].”⁷³

c. Leverage for Negotiations.

With such developments as the 1992 proxy amendments and the increasing popularity of shareholder advisory services, many institutions soon came to realize that they now possess powerful tools for effectuating changes in policy or strategy at targeted firms. For example, beginning in the mid-1990s, CalPERS became one of the most visible institutions to play an openly activist role, often described as a “leader” among activist institutions.⁷⁴ Through its use of shareholder proposals and proxy fights, CalPERS began to target underperforming companies with poor governance practices and then use its influence to improve performance.⁷⁵

But seeking change through a formal shareholder proposal and a proxy solicitation campaign costs institutions considerable amounts of time and money, with no guarantee of success. Despite their large holdings and ability to coordinate, institutions must still bear all the costs of a proxy solicitation campaign while the management of the target firm may draw on corporate funds.

⁷¹ Anabtawi & Stout, *supra* note 4.

⁷² *Id.*

⁷³ *Id.* at 1278.

⁷⁴ Choi & Fisch, *supra* note 7.

⁷⁵ *Id.*

Some institutions also prefer to keep their activism out of the public domain for political reasons.⁷⁶

These considerations have led an increasing number of institutions to turn to private negotiations with management in an effort to convince firms to make governance changes voluntarily.⁷⁷ Boards now know that a motivated and resourceful institution – or group of institutions – can rely on traditional mechanisms such as shareholder proposals and proxy contests to affect corporate change. Even the mere threat of a shareholder proposal is frequently enough leverage to motivate boards to engage in private negotiations due to their desire to avoid the risk of subsequent public scrutiny should the proposal reach a shareholder election.⁷⁸ This is especially true as boards become increasingly cognizant of the risks to their reputation posed by the aggressive nature of many journalists in the financial media.⁷⁹

Of course, even if boards are willing to engage in negotiations, the question remains whether they will be as effective as more formal methods of activism. This is of threshold importance for activist institutions since their goal is always to effectuate desired changes in governance matters or business strategy.⁸⁰

II. THE EFFECTIVENESS OF PRIVATE NEGOTIATIONS

The governance and regulatory climate described above suggests that institutional investors possess the leverage to make the use of private negotiations a viable option for affecting corporate change through the threat of formal activism. Put differently, when shareholders want to talk to boards outside of traditional channels, they now have the muscle to get the ball

⁷⁶ See Kahan & Rock, *supra* note 2 at 1078; Editorial, *CalPERS and Cronyism*, Wall St. J., Oct. 18, 2004, at A18; Jonathon Weil & Joann S. Lublin, *Gadfly Activism at CalPERS Leads to Possible Ouster of President*, Wall St. J., Dec. 1, 2004, at A1.

⁷⁷ See Kahan & Rock, *supra* note 2 at 1078.

⁷⁸ Choi & Fisch, *supra* note 7.

⁷⁹ See Larry E. Ribstein, *The Press, the Trial Lawyers, and Corporations*, IDEOBLOG, June 11, 2008, available at <http://www.typepad.com/services/trackback/6a00d83451c88c69e200e5534b6d898833>.

⁸⁰ See Gillian & Starks, *supra* note 2.

rolling. An inherent challenge in analyzing what happens once boards and shareholders do engage in private negotiations, however, is that they are just that – private. Fortunately, to assist in this effort, several scholars have gained access to the behind-the-scenes communications between activist institutions and target companies and have shared their findings.

In one of the earliest empirical studies to examine private negotiations, Carleton, Nelson and Weisbach focused on the activities of TIAA-CREF and found that the fund has been highly successful in using private negotiations to effectuate governance changes.⁸¹ At the time the study was released in 1998, TIAA-CREF was the single largest pension fund in the U.S., holding approximately one percent of the total U.S. equities market.⁸² Between the years 1992 and 1996, TIAA-CREF targeted 45 firms for the purposes of seeking one of three changes in corporate governance: adoption of confidential voting, reduction of antitakeover devices, and changes in board diversity to promote the appointment of minority or female directors.⁸³ During the jawboning process, TIAA-CREF proved highly successful in obtaining its desired changes. Though it typically started proceedings with the submission of shareholder resolution, in most cases the fund reached an agreement prior to any formal shareholder vote.⁸⁴ Once an agreement was reached, any formal proposal on the table was withdrawn before it could appear on the publicly available proxy statement.⁸⁵ Indeed, the possibility of resolving the issue privately was seen to be a key factor contributing to the high rate of negotiated settlements. Though the agreements that were reached often differed slightly from formal shareholder proposals under submission, they still affected the fundamental changes sought by TIAA-CREF.⁸⁶

All said, in 87% of its engagements the fund successfully used private negotiations to see its desired changes implemented

⁸¹ Carleton, Nelson & Weisbach, *supra* note 7.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*

by the target company.⁸⁷ In the remainder of the cases, firms resisted TIAA-CREF's private pressure and allowed the matter to proceed to a shareholder vote.⁸⁸ Notably, the study concluded that widely held public companies, as opposed to insider-controlled firms, were generally more willing to settle matters privately.⁸⁹ This is likely due to the fact that directors in widely held firms will generally be more concerned about their reputation with future shareholders than insider-controlled firms, and therefore will be more inclined to settle rather than let the matter proceed to a possible public defeat at a corporate election.⁹⁰

Despite the ways in which funds such as TIAA-CREF have been able to use negotiations with management to effectuate change, certain potential limitations must be addressed. First, for institutional investors such as mutual and pension funds, lingering concerns over free-riding persist. Second, the proxy process as described above will only go so far in convincing boards that negotiations are in their own best interests. In other words, over time, some boards have started calling the "bluff" of activist institutions that threaten formal action as a way to spur negotiations. These and other issues are addressed below.

a. *Potential Limitations.*

i. Free-Riding.

Mutual funds and pension funds typically maintain highly diversified portfolios, often meaning that any single fund manager will only hold 1% or less of any single company's stock in the fund portfolio.⁹¹ Mutual funds in particular must comply with the diversification requirements of the Internal Revenue Code if they wish to obtain significant tax benefits. These requirements specify that the mutual fund may own no more than 10% of the outstanding securities of any one company in their portfolio, and that the stock of any single company cannot make up more than

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ See Kahan & Rock, *supra* note 2; Stuart L. Gillian & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, J. APP. FIN. 4, 8-9 (Fall/Winter 2003).

5% of the total value of the fund's assets.⁹² Mutual funds must further comply with the diversification requirements of the Investment Company Act if they hope to advertise themselves as "diversified" – viewed by most funds as industry standard.⁹³ The threshold maximums under this Act are the same as in the Internal Revenue Code.

Holding small stakes in individual funds presents the same rational apathy issues as the dispersed ownership of individual investors.⁹⁴ That is, if an activist institution holding a single-digit percentage of a company's stock wishes to engage that firm on governance or strategy matters, the activist will bear all the expense of doing so while all other shareholders enjoy the benefits despite remaining on the sidelines.⁹⁵

Free-riding concerns have not stopped mutual and pension funds from engaging in activism, but they have influenced their strategies when it comes to negotiations with portfolio companies. Until recently, many of the changes sought by institutional investors over the course of negotiations were relatively modest, with a large percentage being focused on global governance issues rather than firm-specific changes in business strategy.⁹⁶ This is due in part to economies of scale. For pension and mutual funds holding diverse portfolios, it is more economically rational for them to push for broad and widely applicable changes, such as confidential voting, board composition, antitakeover devices, majority voting, and executive compensation, than to take on firm decisions point-by-point.⁹⁷ This is confirmed by a review of the changes sought by TIAA-CREF, which, as discussed above, related to board diversity, confidential voting, and alterations to

⁹² Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1049 (2007).

⁹³ 15 U.S.C. § 80a-5(b).

⁹⁴ See Kahan & Rock, *supra* note 2; Stuart L. Gillian & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, J. APP. FIN. 4, 8-9 (Fall/Winter 2003).

⁹⁵ Stuart L. Gillian & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, J. APP. FIN. 4, 8-9 (Fall/Winter 2003).

⁹⁶ See Kahan & Rock, *supra* note 2 at 1043.

⁹⁷ Choi & Fisch, *supra* note 7 at 347; Black, *supra* note 28 at 580-83; see Kahan & Rock, *supra* note 2 at 1042-44.

antitakeover measures.⁹⁸ The focus on systematic rather than strategy-specific changes is also consistent with the substantial role played by shareholder advisor services in shaping institutional voting patterns.⁹⁹

ii. Systematic Limitations of the Proxy System.

In addition to concerns related to possible free-riding, over time some firms have remained reluctant to privately engage institutions that seek to negotiate with management. For example, some boards often perceive activist institutions as being only interested in self-serving governance changes, such as proposals designed to achieve short-term profits at the expense of long-term corporate interests. Still others realized that many institutions will often be unwilling to follow through with threats of formal action. This is because that even with the 1992 proxy amendments, the proxy system still presents obstacles to institutional activism. In addition to cost, U.S. law limits the ability of shareholders to call special meetings for the purpose of voting on directors. Shareholders must wait until the next regular annual shareholder meeting to present their own candidates or proposals.¹⁰⁰ Moreover, under the corporate law in most states, shareholder proposals that ultimately reach a shareholder vote and gain majority approval are nonbinding on the board if they do not relate to a proper subject for shareholder action.¹⁰¹ Most proposals filed by activist institutions fall within this category.

However, as the next few sections will describe, recent and proposed developments in corporate governance have largely eliminated many of the concerns raised by potential free-riding and the systematic limitations of the shareholder proposal and proxy system. Developments such as the trend toward majority voting and the elimination of broker voting have made it considerably easier for institutions to remove managers whom they perceive to

⁹⁸ Carleton, Nelson & Weisbach, *supra* note 7.

⁹⁹ See Kahan & Rock, *supra* note 2 at 1044.

¹⁰⁰ Lucian Ayre Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); see also Del. Code Ann. tit. 8, § 211(d).

¹⁰¹ See 17 C.F.R. § 240.14a-8(i)(1).

be underperforming.¹⁰² As a result, when shareholders want to negotiate, even boards that were once reluctant are starting to realize that it will often be in their own best interests to participate in a two-way exchange. Those firms that continue to ignore institutions which seek to negotiate do so at their own peril. Moreover, with the rise of activist hedge funds, a group of institutions has emerged that is not content to simply push for broadly applicable and modest changes in strategy or policy, and which is poised to use negotiations to effectuate substantial, firm-specific restructuring.¹⁰³

b. *Majority Voting, Broker Voting, and Additional Proxy Reforms.*

In addition to the 1992 amendments and the increasing influence of shareholder advisory services, several developments aimed at giving shareholders more of a voice within firms have come to fruition or appear likely to do so in the near future. The first concerns the rising number of corporations that now apply majority voting rules in director elections. The traditional default rule in director elections has always been plurality voting, where the director who receives the most votes wins an election even if he or she fails to win a majority of votes.¹⁰⁴ Many institutions opposed the plurality system and engaged in successful activist campaigns that led to a significant percentage of U.S. corporations adopting majority voting rules.¹⁰⁵ According to one study, between 2006 and 2007 the percentage of Fortune 500 companies to adopt majority voting rules increased from 20 to over 50%.¹⁰⁶ The result of majority voting is that “withheld” votes now translate into votes affirmatively *against* a specific candidate.¹⁰⁷ The practical effect of this system is to provide institutions with more leverage over director elections. Directors must now aggressively campaign in order to be sure of obtaining majority approval.¹⁰⁸

¹⁰² See *infra* text accompanying notes 19-22.

¹⁰³ See *infra* text accompanying notes 142-170.

¹⁰⁴ See Security Holder Director Nominations, 68 Fed. Reg. 60,784.

¹⁰⁵ John H. Biggs, *Shareholder Democracy: The Roots of Activism and the Selection of Directors*, 39 LOYOLA U. CHI. L.J. 493, 499 (2008).

¹⁰⁶ Anabtawi & Stout, *supra* note 4 at 1283.

¹⁰⁷ William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459 (2007).

¹⁰⁸ Anabtawi & Stout, *supra* note 4 at 1278.

This has inspired many firms subject to majority voting to actively reach out and engage shareholders prior to elections so that they can gauge investor sentiment on contested issues and director performance.¹⁰⁹

A related development concerns “broker voting.” On July 1, 2009, the SEC approved amendments to New York Stock Exchange Rule 452 that limit the ability of brokers to cast discretionary votes in uncontested director elections.¹¹⁰ Close to 90% of securities traded on public exchanges are held by brokers and financial institutions on behalf of their investor clients.¹¹¹ A large number of those investors do not instruct their brokers on how to vote their shares.¹¹² Under the original language of Rule 452, brokers were allowed to vote these investors’ shares on “routine” matters, which included director elections.¹¹³ Since brokers almost always vote in line with management, the effect of Rule 452 has long been to give incumbent managers a predictable block of broker votes in their favor.¹¹⁴ The amendments to Rule 452, however, no longer classify director elections as routine.¹¹⁵ Accordingly, the effect of the amendments will most likely be the removal of a reliable block of pro-management votes. Though too early to tell, this should give activist shareholders a much more realistic chance of success in mounting challenges to incumbent directors during corporate elections. The practical result of the amendments will be especially significant for those companies that now use majority voting.

Recent proposed changes to the proxy system also suggest that it will soon be easier and cheaper for activist institutions to unseat directors. As mentioned before, a large obstacle to

¹⁰⁹ Keith L. Johnson & Daniel Summerfield, “Shareholder Say on Pay – Ten Points of Confusion,” Shareholder Forum Program on Reconsidering Say on Pay Proposals, Columbia School of Journalism, Oct. 14, 2008 (on file with author).

¹¹⁰ SEC Release No. 34-60215 (July 1, 2009) *available at* www.sec.gov/rules/sro/nyse/2009/34-60215.pdf.

¹¹¹ Anabtawi & Stout, *supra* note 4 at 1278.

¹¹² *Id.*

¹¹³ SEC Release No. 34-59464 (February 26, 2009) *available at* www.sec.gov/rules/sro/nyse/2009/34-59464.pdf

¹¹⁴ Anabtawi & Stout, *supra* note 4 at 1278.

¹¹⁵ SEC Release No. 34-60215 (July 1, 2009) *available at* www.sec.gov/rules/sro/nyse/2009/34-60215.pdf.

shareholder activism is the fact that incumbent directors may generally use corporate funds and resources in a proxy contest whereas investors must rely on their own personal funds and must distribute a separate proxy statement describing their own candidates. A recent proposal by the SEC, however, would allow shareholders holding a specified percentage of shares to include their own director nominees in the company's proxy solicitation materials.¹¹⁶ Under the terms of the proposal, shareholders with at least 1% of voting shares would be allowed to include a nominee in the company's proxy materials in cases where the company has a market value of \$700 million or greater.¹¹⁷ The share ownership threshold increases to 3% for companies with market values between \$75 million and \$750 million, and 5% for companies with market value below \$75 million.¹¹⁸

The proposed rule allows shareholders to aggregate holdings to meet the relevant minimum ownership levels.¹¹⁹ Shareholders must also certify that they have held their shares for at least one year and that they are not holding stock for the purposes of taking control of the company.¹²⁰ With respect to nominees, shareholders are allowed to nominate at least one director but no more than 25% of total board composition.¹²¹

Certain aspects of the SEC's proposal remain unclear, however. For instance, the rule provides that shareholders will be able to include their nominees in company proxy materials "unless the shareholders are otherwise prohibited – either by applicable state law or the company's charter/bylaws – from nominating a candidate for election as director."¹²² Some have opined that this provision is designed to exclude non-voting preferred shares, but it may also be intended to give companies the discretion to exclude certain classes of shareholders – such as union or pension funds –

¹¹⁶ SEC Proposed Rule Release No. 33-9046, available at <http://www.sec.gov/news/press/2009/2009-116.htm>.

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.*

from nominating directors.¹²³ In any event, the new proposal, if adopted, should better enable institutions who meet the various ownership thresholds to engage in activism without bearing all of the cost.

Finally, technological developments cannot be ignored as yet another potential source for more successful activism. Electronic shareholder forums, for instance, have made it easier for large shareholders to communicate with one another and coordinate their strategies.¹²⁴ Professor Gordon has further suggested that institutional investors should stop seeking to persuade the SEC to change the rules for proxy access and instead should focus on engaging in “e-proxy” solicitations when they wish to nominate director candidates.¹²⁵ The SEC’s e-proxy rules reduce the cost of a proxy contest by permitting persons conducting proxy solicitations to furnish materials to shareholders by posting them on an internet site and then notifying shareholders of their availability.¹²⁶

Taken individually or collectively, the foregoing developments present the very real chance of making it easier than ever before for activists to remove directors who they feel are underperforming or operating with misaligned incentives. Thus, from a strategic standpoint, directors who feel vulnerable to potential removal now have additional incentives to engage

¹²³ J.W. Verret, *The Proxy Access Rule*, CONGLOMERATE (May 22, 2009) (on file with author).

¹²⁴ SEC Rule Release No. 34-57172, available at <http://www.sec.gov/rules/final/2008/34-57172.pdf>.

¹²⁵ Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475 (2008).

¹²⁶ Even outside of the context of institutional investors, emerging technology has started to lead individual investors to coordinate their typically small holdings to effectuate governance changes. In one of the most publicized examples, an individual investor owning less than 100 shares of Yahoo stock used social media tools such as blogs to gain enough shareholder support among other individual and institutional investors to successfully campaign for the resignation of Yahoo’s CEO. See Stephen Davis, *Talking Governance: Board-Shareowner Communications on Executive Compensation*, Millstein Center for Corporate Governance, Yale School of Management (2008).

shareholders privately in an effort to enhance their credibility and authority.¹²⁷

A select group of firms has already started speaking directly to institutional shareholders in the wake of these developments – with some directors making the initial overtures themselves. Recent shareholder unrest at companies such as Home Depot, Pfizer and UnitedHealth led these companies to open direct lines of communication with their largest shareholders. To take one example, Bonnie G. Hill, the longest-serving director at Home Depot, Inc., has been described as the epitome of “an emerging breed of directors who reach out to shareholders.”¹²⁸ After being criticized for missing Home Depot’s 2006 annual meeting in the midst of shareholder complaints about the pay of then-CEO Robert Nardelli, Ms. Hill met privately with a group of investors in an effort to ease their anger.¹²⁹ This decision came after the head of the AFL-CIO sent a terse letter to Ms. Hill advocating for a closer link between executive pay and corporate performance.¹³⁰ After the meeting, she was able to alleviate the investors’ concerns by persuading her fellow directors to disband Home Depot’s executive committee and to more closely tie the pay of Mr. Nardelli’s successor to the company’s performance.¹³¹

Subsequently, Ms. Hill participated in a conference call organized by several union pension funds to discuss their concerns about various governance matters at Home Depot.¹³² Two months later, four Home Depot directors met with representatives of the pension funds and proposed a larger town-hall style meeting for the airing of investor concerns.¹³³ At the town hall, three directors addressed questions from approximately forty shareholders, who raised governance issues such as the lack of a separate board chairperson at the company and the company’s strategy for dealing

¹²⁷ Davis, *supra* note 2.

¹²⁸ Joann S. Lublin, *New Breed of Directors Reaches Out to Shareholders; Treading a Fine Line Between Apologist, Sympathetic Ear*, WALL ST. J., July, 21, 2008, at B4.

¹²⁹ *Id.*

¹³⁰ Kaja Whitehouse, *Stuffed Board*, WALL ST. J., April 9, 2007, at R4.

¹³¹ Joann S. Lublin, *New Breed of Directors Reaches Out to Shareholders; Treading a Fine Line Between Apologist, Sympathetic Ear*, WALL ST. J., July 21, 2008, at B4.

¹³² *Id.*

¹³³ *Id.*

with the downturn in the housing market.¹³⁴ After this meeting, the Home Depot board named Ms. Hill its lead director – a role that includes acting as a “heat shield” against dissatisfied investors.¹³⁵

Another company whose directors have recently started communicating directly with shareholders is Pfizer. In 2007, the global pharmaceutical manufacturer announced that it would become the first company in the U.S. to hold regular meetings between its board of directors and largest shareholders to discuss topics ranging from executive compensation to management practices.¹³⁶ The first such meeting occurred in 2007 and was attended by shareholders who collectively held approximately thirty-five percent of Pfizer’s stock.¹³⁷ This built on Pfizer’s existing policy of forwarding every shareholder communication to the board, including simple emails and letters, and then sending responses in a timely manner.¹³⁸ Pfizer also dropped restrictions that previously prevented directors from meeting with shareholders on their own initiative.¹³⁹

UnitedHealth Group, Inc. has taken a similar approach and privately engages shareholders on both an *ad hoc* basis and through a formal shareholder advisory committee on board nominations.¹⁴⁰ Other firms have held open-invitation shareholder meetings separate from the annual shareholder meeting, formed informal shareholder advisory groups, and assigned internal teams dedicated to responding to specific shareholder inquiries.¹⁴¹

c. The Rise of Activist Hedge Funds.

Despite the developments that continue to make it easier and cheaper for institutional investors to coordinate and influence

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ Shannon Pettypiece, *Pfizer Will Start Meetings With Largest Investors*, BLOOMBERG, June 28, 2007.

¹³⁷ CORPORATE GOVERNANCE, *Pfizer to Meet with Largest Shareholders*, June 2007, available at <http://corp.gov.net/news/archives2007/June.html>.

¹³⁸ National Association of Corporate Directors, *Framework and Tools for Improving Board-Shareowner Communications* (2004) (on file with author).

¹³⁹ *Id.*

¹⁴⁰ Stephen Dean, *Board-Shareholder Dialogue: Why They’re Talking*, RiskMetrics, Feb. 10, 2009.

¹⁴¹ Davis, *supra* note 2.

firms, as discussed previously, for some institutions there remain issues concerning free-riding by other shareholders.¹⁴² For one specific type of institution, however, the free-riding problem faced by mutual and pension funds does not always present a significant obstacle to activism. Hedge funds, historically lightly regulated investment funds used predominantly by very wealthy investors, have emerged as institutions that are willing to actively engage portfolio companies in order to affect substantial changes in firm governance and strategy.¹⁴³

Unlike other types of funds, hedge funds generally do not hold highly diversified portfolios.¹⁴⁴ They often take large positions in a handful of firms and then use their standing as shareholders to push for aggressive wealth maximization. This can entail applying public pressure on a portfolio company's board, maintaining a proxy contest to unseat incumbent management, or filing litigation against current or former managers.¹⁴⁵ What's more, hedge funds typically rely on activism as a part of their profit-making strategy by identifying underperforming firms *ex ante* and then using their stakes in those firms to bring about the changes they seek.¹⁴⁶ Other institutions, by contrast, typically invest in a wide range of firms, and only then perform an analysis of which might benefit from direct engagement.¹⁴⁷ Hedge funds are also able take advantage of the 1992 proxy amendments to form groups, described as "wolf packs," to purchase even larger percentages within their chosen firms.¹⁴⁸

No longer satisfied to target only small and midsize companies, in recent years hedge funds have bought large positions in such storied corporations as McDonald's and Time Warner.¹⁴⁹

¹⁴² Kahan & Rock, *supra* note 2; Stuart L. Gillian & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, J. APP. FIN. 4, 8-9 (Fall/Winter 2003).

¹⁴³ Kahan & Rock, *supra* note 2 at 1062-63.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ See William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L. J. 1375 (2007); Phyllis Plitch, *Lawyers See No Poison Pill to Feed Hedge Fund 'Wolf Packs'*, CORP. GOVERNANCE, Dec. 21, 2005.

¹⁴⁹ See Anabtawi & Stout, *supra* note 4 at 1279; Jesse Eisinger, *Hedge-Fund Man at McDonald's*, WALL ST. J., Sept. 28, 2005; Andrew Ross Sorkin &

In fact, it was the targeting of Time Warner by a group of hedge funds that led Marty Lipton to say that “we have gone from the imperial CEO to the imperial stockholder.”¹⁵⁰

d. *Hedge Funds and Negotiations with Management.*

The fact that hedge funds frequently hold large positions in a small group of companies suggests that they are well suited for using private negotiations to effectuate governance changes. This has been confirmed by a 2008 empirical study by researchers at the London Business School that examined the ways in which the Hermes UK Focus Fund (HUKFF) targets underperforming companies and then actively engages them in private negotiations on governance changes. HUKFF is managed by Hermes, which in turn is owned by the British Telecom Pension Scheme, one of the four largest pension funds in the United Kingdom.¹⁵¹ HUKFF has been described as a hybrid fund, but is similar in most respects to a U.S. hedge fund in that it was created to address the problem with free-riding faced by mutual funds.¹⁵² The trustees of HUKFF believed that the fund should consist primarily of shares from a small group of underperforming companies that could be engaged more intensively on a company-by-company, issue-by-issue basis.¹⁵³

When it decides to engage companies, HUKFF relies primarily on private negotiations at the outset rather than the submission of shareholder proposals.¹⁵⁴ It applies three criteria when evaluating which portfolio funds to target. It asks whether the target is underperforming, whether the fund believes it can successfully engage the company, and whether the fund expects to achieve at least a 20% increase in the value of the target’s current share price.¹⁵⁵ If all three factors are present, the fund will make

Richard Siklos, *Icahn Tries to Form a Team to Take on Time Warner*, N.Y. TIMES, Aug. 10, 2005, at C1.

¹⁵⁰ THE ECONOMIST, *Shareholder Democracy: Battling for Corporate America*, March 11, 2006.

¹⁵¹ *Id.*

¹⁵² Becht et al., *supra* note 7.

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

private contact with the target and open a line of communication regarding desired changes.¹⁵⁶ If the target agrees to implement the requested changes, the fund will simply monitor the situation to ensure compliance.¹⁵⁷ If the target reacts negatively to the fund's requests, the situation will become more confrontational.¹⁵⁸ At that point, the fund may choose to threaten a public press campaign or takeover attempt.¹⁵⁹

Ultimately, HUKFF engaged 30 of the 41 companies it invested in during the period from 1998 to 2004, primarily through multiple private meetings, telephone calls, and letters between fund representatives and CEOs, CFOs, divisional managers, investment relations staff, and board members.¹⁶⁰ The fund never contacted banks or bondholders, but did occasionally communicate with other institutional shareholders to seek their support for its efforts.¹⁶¹ However, joint undertakings with other institutions only occurred in three cases.¹⁶²

At 28 of the 30 companies targeted by HUKFF, the fund requested substantial restructuring, such as the sale of non-core divisions or assets.¹⁶³ Through the use of private negotiations it was successful in approximately 50% of such cases.¹⁶⁴ In more than half of its engagements, the fund sought increased cash payouts to shareholders or to replace the target company's CEO so that someone more inclined to adopt the fund's recommendations could be appointed.¹⁶⁵ These efforts were highly successful, achieving the desired result over 75% of the time.¹⁶⁶ Moreover, once the changes were made by target firms, the study found that their share prices increased substantially – by as much as 6% immediately following disclosure of the change to the market.¹⁶⁷

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *See id.*

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

A review of HUKFF's use of negotiations to effectuate governance changes suggest that U.S. hedge funds – likewise positioned to solve the freer-riding problems faced by other institutional investors – could follow its example and use private negotiations to effectuate structuring changes in the shadow of the threat of activism. However, some have suggested that U.S. hedge funds tend to avoid private forms of activism in favor of more open and public methods.¹⁶⁸ To be sure, U.S. hedge fund activism often takes the shape of public shaming campaigns aimed at a target firm. In one prominent example, a hedge fund attacked the CEO of a target firm personally, saying that “It is time for you to step down . . . so that you can do what you do best: retreat to your waterfront mansion in the Hamptons where you can play tennis and hobnob with your fellow socialites.”¹⁶⁹ One month later the CEO resigned.

This and other examples may indicate that before U.S. hedge funds will turn to private negotiations as part of their activism, they will first need to adopt a less adversarial mindset. However, this is not the case will all hedge funds. A study by Brav, Jiang, Thomas, and Partnoy reveals that U.S. hedge funds frequently rely on private negotiations with management of target companies. Using data of U.S. hedge fund activity from 2001-2006, these scholars found that “hedge fund activists are openly hostile in less than 30% of cases (hostility includes a threatened or actual proxy contest, takeover, lawsuit, or public campaign that is openly confrontational). More commonly, hedge fund activists cooperate with managers, at least at the initial stages of their intervention, and achieve all or most of their stated goals in about two-thirds of all cases.”¹⁷⁰

One caveat does apply when comparing the activities of HUKFF and U.S. hedge funds. As the study of HUKFF itself concludes, there are several key differences between the legal regimes in the U.S. and U.K. that provide British funds with additional sources of leverage to encourage private negotiations.

¹⁶⁸ Kahan & Rock, *supra* note 2 at 1078.

¹⁶⁹ *See id.*

¹⁷⁰ Alon Brav, Wei Jiang, Randall S. Thomas, Frank Partnoy, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, __ J. FIN. __ (forthcoming 2009).

First, as Professor Bebchuk has noted, under U.S. law shareholders cannot initiate changes to a company's charter.¹⁷¹ By contrast, in the U.K. shareholders may initiate changes in the basic corporate contract through a shareholder vote.¹⁷² A similar difference concerns the election of directors. While the U.S. has experienced an increasing trend toward majority voting, just under half of all corporations continue to use a plurality system where directors receiving the most votes win regardless of whether they earn a majority. In the U.K., the default system for all corporations is majority voting, making it easier for activists to unseat incumbent management.¹⁷³ Moreover, holders at least 10% of voting stock in the U.K. have the ability to call extraordinary general meetings at any time for the purpose of voting on the removal of directors.¹⁷⁴ If a resolution seeking the dismissal of a director wins over 50% of the votes cast at an extraordinary meeting the director is required to resign.¹⁷⁵ In the majority of U.S. jurisdictions, however, shareholders cannot call extraordinary meetings unless authorized by express provisions in their corporate charter.¹⁷⁶ The relative ease with which shareholders in the U.K. may call special meetings and vote on the removal of directors thus provides their targeted boards with an additional incentive to engage funds that seek negotiations. Nevertheless, the work of Brav, Jiang, Thomas, and Partnoy described above suggests that these systematic differences might not be as significant of a limitation to U.S. hedge fund activism as originally thought.

Finally, whenever one speaks of hedge fund activism, it is important to keep in mind that some have suggested hedge funds frequently operate under conflicts of interest.¹⁷⁷ In one type of situation, hedge funds have been seen to take adverse positions in securities or other instruments issued by other companies. Thus, a

¹⁷¹ Lucian Ayre Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 847-50 (2005).

¹⁷² *Id.*

¹⁷³ *Id.* at 833.

¹⁷⁴ *Id.*

¹⁷⁵ See Becht et al., *supra* note 7.

¹⁷⁶ See Del. Code Ann. tit. 8 §§ 141(a), 211(d).

¹⁷⁷ See Anabtawi & Stout, *supra* note 4. Professors Anabtawi & Stout propose extending the fiduciary duties traditionally owed by directors to institutional investors as a way to protect firm interests from shareholder conflicts of interest. *Id.*

hedge fund might become a formal shareholder – with corresponding voting power – in one company while simultaneously hedging away its economic interest through shorting the company’s shares or entering into a derivatives contract.¹⁷⁸ This in turn would make it in the hedge fund’s best interest to engage in activism that would seek governance or strategy changes designed to lower share price values.

A similar issue is raised when an activist purchases securities in another company and then takes an adverse position. As described by commentators, “a hedge fund that owns shares in Company A may try to use that position to increase the value of another position, say in Company B, rather than to maximize the share price of Company A.”¹⁷⁹ This scenario was well-publicized during the narrow approval of the merger between the French company AXA and MONY, a publicly held insurance corporation.¹⁸⁰ A group of hedge funds with large shareholdings in MONY supported the merger because they also held convertible debt issued by AXA, the value of which would rise substantially once the deal went through.¹⁸¹

Another example to receive considerable attention in both the financial media and the legal literature involved the potential purchase of King Pharmaceuticals by Mylan Laboratories. Perry Capital, a hedge fund, purchased close to 10% of Mylan stock and shortly thereafter supported the acquisition despite the opinions of most market analysts that the asking price was too high.¹⁸² However, Perry was also a significant holder in King, and had used

¹⁷⁸ “Shorting” refers to the practice where one investor borrows stock from a brokerage firm and then sells it to a third party. After the investor has sold the stock, she must buy the stock on the open market to replace the borrowed stock. If the price of the stock has declined by the time the investor makes her open-market purchase, she will make a profit by purchasing the shares at a price lower than the price for which she originally sold the stock. If the price of the stock increases, however, the investor will suffer a loss when she purchases it at the higher price. See Brigitte Yuille, *Short Selling*, Forbes Investopedia, at <http://www.investopedia.com/university/shortselling/shortselling1.asp>.

¹⁷⁹ Kahan & Rock, *supra* note 2 at 1071.

¹⁸⁰ *Id.* at 1073.

¹⁸¹ *Id.*

¹⁸² Scott J. Davis, *Would Changes in the Rules for Director Selection and Liability Help Public Companies Gain Some of Private Equity’s Advantages?* 76 U. CHI. L. REV. 83, 97 n.60 (2009); Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 153 (2009).

a derivatives contract to hedge away its economic interest in the Mylan stock it had recently purchased.¹⁸³ Thus, Perry stood to reap a substantial profit if Mylan overpaid in its acquisition of King.

The manner and frequency in which activist hedge funds press for change while suffering a conflict of interest is only just starting to become fully apparent. One recent empirical study found that in fifty situations where an activist hedge fund launched a campaign within a target firm over a twenty-month period, only six cases involved what the researchers called “questionable situations.”¹⁸⁴ In those cases, the hedge fund had a clear conflict of interest due to investments or derivative contracts with other companies. However, as the researchers acknowledged, this figure may be under-representative of cases involving similar conflicts.¹⁸⁵ Hedge funds must only disclose their interests in a 13D filing when they acquire 5% or more of a company’s securities. Thus, “a competently advised fund that is truly bent on behavior that might not do well in the sun is simply not going to purchase enough shares to require a Schedule 13D filing.”¹⁸⁶ As a result, when firms negotiate with hedge funds, directors and other institutions will need to remain cognizant of possible hedge fund motivations in order to ensure that the product of any negotiations will be in the best interests of the company and shareholders as a class.

III. EVALUATING THE POTENTIAL BENEFITS OF NEGOTIATIONS

With the added leverage created by developments such as majority voting and the rise of powerful activist hedge funds, boards will frequently feel compelled to engage those institutions who seek negotiations. The examples of Home Depot and HUKFF further demonstrate that negotiations can be a highly effective way for institutions to effectuate governance changes. These cases have prompted several regulators, policymakers, and investor interest groups to make recent calls in favor of more frequent

¹⁸³ Davis, *supra* note 181 at 97 n. 60; Thompson & Edelman, *supra* note 181 at 153.

¹⁸⁴ Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681 (2007).

¹⁸⁵ *See id.*

¹⁸⁶ *See id.*

board-shareholder negotiations. For instance, as the global recession dominated headlines in October 2008, the National Association of Corporate Directors (NACD) released its list of ten “key agreed principles” to strengthen corporate governance. The tenth principle on the NACD’s list provided that “[g]overnance structures and practices should be designed to encourage communication with shareholders,” and suggested that “boards should consider ways to engage large long-term shareholders in dialogue about corporate governance issues and long-term strategy issues.”¹⁸⁷ The NACD noted that such dialogue may occur through traditional channels, such as the proxy statement and annual report, but added that a private meeting with shareholders may also be beneficial.¹⁸⁸

Additionally, the increasing willingness of firms to begin opening direct lines of communication with shareholders inspired several to sign the Aspen Principles on Long-Term Value Creation in April 2009. These Principles – signed by six major corporations (including PepsiCo, Pfizer, and Xerox), seven of the country’s largest institutional investors (including CalPERS and TIAA-CREF), and a group of leading corporate attorneys and policy groups – commit the signatories to holding regular talks on a wide range of governance issues, including long-term business strategy and executive compensation.¹⁸⁹

Regulators, too, have not been shy about expressing their desire for greater transparency and more communication within firms. The U.S. Department of Labor has urged pension funds to regularly speak with management at portfolio companies.¹⁹⁰ Several Commissioners with the SEC have spoken publicly of the need for greater levels of communication between firms and

¹⁸⁷ National Association of Corporate Directors, *Key Agreed Principles to Strengthen Corporate Governance for US Publicly Traded Companies* at 11 (2008) (on file with author).

¹⁸⁸ *Id.*

¹⁸⁹ ASPEN PRINCIPLES ON LONG-TERM VALUE CREATION: GUIDING PRINCIPLES FOR CORPORATIONS AND INVESTORS, THE ASPEN INSTITUTE (April 2009).

¹⁹⁰ Stuart L. Gillian & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, J. APP. FIN. 4, 9-10 (Fall/Winter 2003)

shareholders.¹⁹¹ The SEC itself has also proposed several measures aimed at promoting communications between firms and shareholders, including a rule that would require companies to disclose whether they have processes in place for allowing shareholders to communicate directly with board members or officers, and if not, why not.¹⁹²

In light of the increased attention being paid to board-shareholder negotiations, an obvious question arises as to what benefits, if any, do shareholders or boards accrue by relying on negotiations over other forms of activism? For many institutional investors and boards, private negotiations fill a gap in traditional governance activities. They result in an exchange of information that has the potential to resolve differences and prevent resort to more formal, confrontational, and expensive forms of activism like proxy contests or litigation. For their part, hedge funds have the capability to use behind-the-scenes negotiations to enact substantial structural changes in target firms. These and other potential effects are discussed below.

a. *Cost-Savings.*

The activities of TIAA-CREF and public pension funds suggest that private negotiations provide certain key benefits from the perspective of both institutional investors and target boards. For one, the specific ways in which institutions use private negotiations to influence management – including telephone calls, letters, and in-person meetings – are all relatively low-cost.¹⁹³ Not only does this make them feasible for smaller funds that do not have the necessary resources for more formal engagement processes, but it also makes them attractive to all firms that wish to

¹⁹¹ See Dealbook, “S.E.C. Commissioner Backs ‘Say on Pay’,” Feb. 19, 2009, available at <http://dealbook.blogs.nytimes.com/2009/02/19/sec-commissioner-backs-say-on-pay/>; Remarks of SEC Commissioner Elisse B. Walter, “Corporate Governance – A Master Class 2009,” PLI, Feb. 18, 2009; Remarks of SEC Commissioner Luis A. Aguilar at “The SEC Speaks in 2009,” Washington, D.C. (Feb. 6, 2009) (on file with author).

¹⁹² National Association of Corporate Directors, *Framework and Tools for Improving Board-Shareowner Communications* (2004).

¹⁹³ Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315 (2008).

avoid the cost and time associated with shareholder proposals or litigation.

Reliance on private negotiations over litigation or proxy contests will also often save on the need to hire outside advisors and counsel.¹⁹⁴ This is especially important for public pension funds, which typically do not have a separate budget for corporate governance activities.¹⁹⁵ In fact, the cost-savings of negotiations appears to be playing out in practice as firms work to allocate resources to their activist pursuits. One study of public pension funds found that these institutions either meet privately with management or engage in written correspondence 40-45% of the time.¹⁹⁶ By contrast, the same funds only sponsor shareholder proposals or solicit votes on proposals between 15 and 17.5% of the time, respectively.¹⁹⁷

In addition, through the use of private negotiations, boards have also experienced cost-savings in the form of an overall reduction in the number and frequency of shareholder proposals and proxy fights. As the activities of TIAA-CREF and CalPERS indicate, activist funds often submit proposals in order to alert a target company of their desire to open lines of communication. These resolutions are typically withdrawn once the institution perceives a willingness on the part of the target to engage in an informal dialogue. For example, in 2007, 665 shareholder proposals were submitted in the United States and approximately half were later withdrawn.¹⁹⁸ Market analysts contend that the steadily increasing number of withdrawn proposals is due in large part to “frank dialogue” between activist funds and boards during private meetings or telephone calls.¹⁹⁹ Leading corporate law

¹⁹⁴ See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1051 (2007). For many activists, the most time and expense involved in negotiations may be upfront as they seek to identify which firms to target. This could entail the hiring of outside advisors. *Id.*

¹⁹⁵ Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 346-54 (2008) (reporting that less than 20% of pension funds maintain a separate budget for activism).

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ CORPORATE SECRETARY, *Arming Yourself Against Activists*, June 2008.

¹⁹⁹ *Id.*

firms have accordingly advised their director clients to consider engaging in private negotiations with activists in light of the declining number of shareholder proposals that ultimately reached a vote in recent years. As described in a client memorandum from Wachtell, Lipton, Rosen & Katz, “one of the primary lessons to emerge from the 2008 proxy season is that effective company-shareholder communication does make a difference.”²⁰⁰

b. *Transparency, Monitoring, and Dispute Resolution.*

For shareholders, and particularly institutional investors, private negotiations also have considerable promise with respect to their ability to monitor the alignment of managerial incentives with shareholder interests. For institutions to be able to effectively serve as monitors within firms, in many cases they will need access to inside information about company policies or strategies.²⁰¹ Inside information is often confidential and more appropriate for one-on-one private meetings – with appropriate safeguards – as opposed to inclusion on an annual report or proxy statement.

For example, in order for boards and shareholders to engage in meaningful negotiations on executive compensation policies and procedures, shareholders will need to have access to inside information that describes performance targets and peer benchmarks.²⁰² Such information is generally treated as competitive information and thus not included in the standard compensation disclosures mandated by the SEC.²⁰³ Without it, however, it will be difficult for boards and shareholders to reach a consensus on pay packages. Designing efficient compensation must be crafted on a firm and individual-specific basis to provide managers with proper incentives.²⁰⁴ This likely explains why, of

²⁰⁰ David A. Katz & Laura A. McIntosh, Client Memorandum, *Corporate Governance Update: Shareholders Focused on Stability in Proxy Votes*, Wachtell Rosen Lipton & Katz, Oct. 30, 2008 (on file with author).

²⁰¹ Frederick Tung, *Leverage in the Boardroom: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. __ (forthcoming 2009).

²⁰² Edward Labaton and Ethan Wohl, *Selective ‘Say-on-Pay’ the Best Remedy*, EXECUTIVE COUNSEL (Nov./Dec. 2008).

²⁰³ *Id.*

²⁰⁴ Larry Ribstein, *The SEC: From Fraud Accessory to Quack Corporate Governance*, IDEOBLOG (Feb. 19, 2009).

all activists, hedge funds have been the most proactive in seeking board representation – even if only minority representation.²⁰⁵ They appear driven to at least be able to present their views on governance and strategy issues, even if their votes are nonbinding.

Further, by simply explaining their reasoning during the course of negotiations, boards will often be able to stave off proxy contests or litigation. As leading law firms recommend, engagement also does not require waiting until crises develop.²⁰⁶ Communicating with shareholders throughout the year will help both boards and shareholders gain a better understanding of the issues that each side considers important.²⁰⁷ This will enable boards to predict what issues might lead to confrontation, and it may also help establish relationships with key shareholders that could be of later assistance in the event of a proxy contest or hostile takeover attempt.²⁰⁸

Further, by engaging in private negotiations directly with shareholders outside of the formal context of a shareholder resolution, directors may discover ways to modify their plans or procedures in such a manner as to obviate an activist's desire to submit a proposal or engage in other formal methods of confrontation in the first place.²⁰⁹ Returning again to the example of executive pay, firms benefit through negotiations by obtaining feedback on remuneration policies, thereby “enabling them to revise plans, better anticipate and perhaps preempt resistance, and/or manage risks of opposition.”²¹⁰ This may even be accomplished without necessarily giving into more demands than

²⁰⁵ Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 318-19 (2008); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

²⁰⁶ Georgeson, Inc. and Latham & Watkins, *Strategies for Dealing with Shareholder Proposals*, Corp. Gov. Commentary (Dec. 2008) (on file with author).

²⁰⁷ *See id.*

²⁰⁸ *See id.*

²⁰⁹ *See id.*

²¹⁰ Stephen Davis, *Does ‘Say on Pay’ Work? Lessons on Making CEO Compensation Accountable*, MILLSTEIN CENTER FOR CORPORATE GOVERNANCE, YALE SCHOOL OF MANAGEMENT (2007) (on file with author).

the board is comfortable with.²¹¹ Moreover, managers are not infallible. An institutional shareholder with significant resources may be able to offer expertise that causes a board to see an issue in a different strategic light.²¹² Resolving differences through private negotiations may then save the parties from resorting to lengthy proxy campaigns or litigation as each side attempts to explain its viewpoints.²¹³ In the case of preempted litigation, negotiations would provide the added benefit of lessening the burdens on an already over-strained court system.

If nothing else, corporate attorneys note that a willingness to enter negotiations may buy the target firm additional time to study the issues raised by the activist.²¹⁴ Then, based on a deeper analysis of the issues, the firm can attempt to use supporting data or memoranda in its efforts to persuade the shareholder to drop the matter altogether. Indeed, as discussed previously, the legitimate efforts to engage shareholders by several boards' have led to a significant number of shareholder proposals being withdrawn prior to their publication on a proxy statement. Should a board be able to convince the proposal's proponent itself – or another influential investor – that the proposal is not in the best interests of the company, the firm might then be able to rely on that institution's help in convincing others to vote against the original proposal even if the deadline for withdrawing a proposal from the annual proxy statement has passed.²¹⁵

If, however, private negotiations fail to resolve the matter raised by a shareholder proposal, they still might be of use to the targeted firm. As mentioned previously, shareholder advisory

²¹¹ National Association of Corporate Directors, *Framework and Tools for Improving Board-Shareowner Communications* (2004); Georgeson and Latham & Watkins, *Strategies for Dealing with Shareholder Proposals*, CORPORATE GOVERNANCE COMMENTARY (Dec. 2008) (on file with author).

²¹² National Association of Corporate Directors, *Framework and Tools for Improving Board-Shareowner Communications* (2004).

²¹³ Georgeson and Latham & Watkins, *Strategies for Dealing with Shareholder Proposals*, CORPORATE GOVERNANCE COMMENTARY (Dec. 2008) (on file with author).

²¹⁴ David A. Katz & Laura A. McIntosh, Client Memorandum, *Corporate Governance Update: Shareholders Focused on Stability in Proxy Votes*, Wachtell Rosen Lipton & Katz, Oct. 30, 2008 (on file with author).

²¹⁵ Georgeson and Latham & Watkins, *Strategies for Dealing with Shareholder Proposals*, CORPORATE GOVERNANCE COMMENTARY (Dec. 2008) (on file with author).

services play a key role in the voting activities of institutional investors. Attorneys have found that directors who privately negotiate with the proponent of a shareholder proposal will later be able to explain to shareholder advisory services and other institutional investors that they openly discussed the matter with the proponent, but, in their exercise of business judgment, could not comply without putting corporate interests at risk.²¹⁶ By fully explaining the basis for its position to RiskMetrics, as one example, a board may thus be able to sway the advisory service's recommendation when the time comes for a corporate vote.

On the other hand, if a director feels as though a shareholder advisory service might recommend voting against his or her stay on the board, private and sustained outreach to key shareholders might make them less likely to simply follow the service's recommendations without question.²¹⁷ That is, if activists feel as though their views are valued by a firm, they may be less inclined to use their new-found sources of authority before at least hearing the board's position. Thus, in the words of Stephen Davis at the Yale School of Management, "informed [institutions] . . . might vote 'yes' even when their proxy advisor counsels 'no.'"²¹⁸ This should be of especial interest to vulnerable directors in light of data showing that shareholders typically vote in accordance with the recommendations of their advisory services in least 75% of all corporate elections.²¹⁹

Even if boards and shareholders are unable to agree on every issue, simply enhancing corporate transparency through private communications will likely have several additional knock-on effects. Some activists simply want to be heard.²²⁰ If a board is unwilling to privately engage them on the issues they raise, however, these shareholders may feel forced to threaten a proxy battle or engage in an aggressive public relations campaign.²²¹ In

²¹⁶ *Id.*; Davis, *supra* note 2.

²¹⁷ Georgeson and Latham & Watkins, *Strategies for Dealing with Shareholder Proposals*, CORPORATE GOVERNANCE COMMENTARY (Dec. 2008) (on file with author); Davis, *supra* note 2.

²¹⁸ Davis, *supra* note 2.

²¹⁹ *See id.*

²²⁰ CORPORATE SECRETARY, *Arming Yourself Against Activists*, June 2008 (on file with author).

²²¹ *See* Anabtawi & Stout, *supra* note 4 at 1296-98.

one recent example, activists successfully launched a withhold vote campaign against the chair of ExxonMobil's public issues committee after he refused to meet with them to discuss issues relating to climate change.²²²

Of course, boards may face some practical difficulties if they privately engage shareholders in negotiations. For example, shareholders may begin to feel entitled to frequent meetings with directors, and, if turned down, may fall back to more aggressive mechanisms as proxy contests, litigation, or public shaming.²²³ If meetings become too frequent, however, companies will be forced to spend considerable time and resources preparing for and participating in them, which in turn will draw attention away from corporate operations.²²⁴ To counteract these concerns, firms may wish to follow the examples of Home Depot and Pfizer, which have designated specific directors to handle initial negotiations with shareholders. Further, to protect against any perception that a firm has delegated too much power to investors, boards may wish to take steps that will clarify the informational nature of meetings with shareholders.²²⁵ Thus, when UnitedHealth created a shareholder advisory committee on director nominations, it provided notice to all participating shareholders stating that, "All viewpoints expressed in the advisory committee are advisory in nature only and the nominating committee and board . . . are under no obligation to follow any such viewpoints."²²⁶

A final issue that boards and institutions must be aware of when engaging in private negotiations is the possibility of conflicts of interest. The potential for conflicts does not override the many benefits of negotiations, but it does suggest that the parties must go

²²² CORPORATE SECRETARY, *Arming Yourself Against Activists*, June 2008 (on file with author).

²²³ Martin Lipton, Steven A. Rosenblum & Karessa L. Cain, Client Memorandum, *Some Thoughts for Boards of Directors in 2009*, Wachtell Lipton Rosen & Katz (Dec. 8, 2008) (on file with author).

²²⁴ *See id.*

²²⁵ Davis, *supra* note 2.

²²⁶ Stephen Davis, *Talking Governance: Board-Shareowner Communications on Executive Compensation*, MILLSTEIN CENTER FOR CORPORATE GOVERNANCE, YALE SCHOOL OF MANAGEMENT (2008) (quoting UnitedHealth Group Nominating Advisory Committee Description, available at http://www.unitedhealthgroup.org/about/Advisory_Committee_Description.pdf) (on file with author).

into any private engagement with their eyes open. Individual shareholders will often have differing opinions about how a firm should be operated and to what end. This does not present potential problems so long as the motivation is not the economic self-interest of one shareholder to the detriment of other shareholders. However, several types of shareholders and transactions raise such concerns.²²⁷

For example, mutual funds often hold interests in companies where they also manage a corporate pension fund.²²⁸ These funds may feel that their corporate pension fund operations – a significant source of revenue – will be at risk if they argue too aggressively against the decisions of company management.²²⁹ Indeed, mutual fund managers have indicated that their corporate pension fund business would be put at risk by simply voting against management or expressing an interest in reforming executive compensation.²³⁰ Mutual funds may also suffer from a conflict based on their relationships with fund beneficiaries. Several are affiliated with other financial institutions, such as insurance companies.²³¹ Managers at these funds may fear upsetting present or future clients of the affiliated institutions through activist behavior.²³²

Union and public pension funds raise their own conflicts concerns. For example, union pension funds are often cast in the middle of disagreements between labor and management.²³³ In one high profile example of this type of conflict, CalPERS actively campaigned to have the CEO of Safeway, Inc. – Steven Burd –

²²⁷ See Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006). Professors Stout and Anabtawi suggest that fiduciary duties should be extended to activists that use their influence to promote a specific transaction that enables it to capture a personal economic benefit not captured by shareholders generally. Anabtawi & Stout, *supra* note 4.

²²⁸ Marcel Kahan & Edward B. Rock, *Hedge Funds and Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1055 (2007).

²²⁹ *Id.*

²³⁰ *Id.* (quoting John Bogle, the former head of Vanguard, as saying that votes against management by a mutual fund could “jeopardize the retention of clients of 401(k) and pension accounts.”).

²³¹ *Id.*

²³² *Id.*

²³³ See Editorial, *CalPERS and Cronyism*, WALL ST. J., Oct. 18, 2004, at A18; Jonathon Weil & Joann S. Lublin, *Gadfly Activism at CalPERS Leads to Possible Ouster of President*, WALL ST. J., Dec. 1, 2004, at A1.

removed from his position.²³⁴ At the time, Burd was unwilling to give into certain concessions demanded by the United Food & Commercial Workers Union, a labor union representing grocery workers.²³⁵ During the course of events, however, it became known that the campaign to remove Burd had been orchestrated by CalPERS's president, Sean Harrigan, who also worked in an official capacity for the United Food & Commercial Workers Union.²³⁶ Once Harrigan's conflict was revealed, Burd survived the attempt to have him removed.²³⁷ However, CalPERS was perceived to working on behalf of the union – rather than its entire class of beneficiaries – in its efforts to gain labor concessions resisted by management.²³⁸ Public pension funds also raise the concern that they are susceptible to undue political influence. The boards of trustees of these funds are usually comprised of gubernatorial appointees, elected officials, and representatives elected by fund beneficiaries.²³⁹ These individuals may be subject to pressures placed on them by constituents who might have diverging interests, and thus may be tempted to pursue political rather than investment goals.²⁴⁰

Despite the many advantages that negotiations provide to shareholders seeking to engage management, proponents of the practice often overlook a significant regulatory barrier: the SEC's Regulation "Fair Disclosure" (Regulation FD). This concern is addressed in the next section.

IV. THE PROBLEM OF REGULATION FD

a. *Background on Regulation FD.*

In order for negotiations to produce the types of benefits described in this Article, by definition boards and shareholders

²³⁴ See Anabtawi & Stout, *supra* note 4.

²³⁵ *See id.*

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

²⁴⁰ Marcel Kahan & Edward B. Rock, *Hedge Funds and Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1059 (2007); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

must be able to freely engage in a two-way exchange of information. For example, to stave off proxy fights or litigation, boards may need to explain their positions to satisfy the concerns of shareholders.²⁴¹ This will often require the use of supporting data or information – some of which may be confidential.²⁴² Similarly, for institutional investors to be able to serve as effective monitors of director behavior, the calculus must include the level of information that they have access to regarding the issues facing their firms.²⁴³

However, the degree to which directors may freely disclose information during the course of negotiations is substantially limited by the SEC’s Regulation “Fair Disclosure” (Regulation FD). Regulation FD prohibits boards from disclosing material nonpublic information to shareholders if they are unwilling or unable to disclose the same information to the general public. The Regulation was enacted out of concerns over the trading in securities following an issuer’s selective disclosure of information to certain market participants.²⁴⁴ Prior to its enactment, public companies would often selectively disclose nonpublic material information to securities analysts and institutional investors before making widespread disclosure of the same information.²⁴⁵ This was typically done to assist the parties in making more accurate assessments of the disclosing company’s present or future performance.²⁴⁶ Critics of this practice claimed that “such ‘selective disclosure’ . . . put[s] small investors at a disadvantage to the analysts, brokers, and institutional investors who [are] routinely

²⁴¹ See *supra* text accompanying notes 35-39.

²⁴² See *supra* text accompanying notes 35-36.

²⁴³ See Tung, *supra* note 31.

²⁴⁴ Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590-72,592 (Dec. 28, 1999); ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND AMERICA DON’T WANT YOU TO KNOW 93 (2002) (“We purposely chose [the] name [Regulation Fair Disclosure] to make our opponents think twice about fighting it.”).

²⁴⁵ See Mark I. Steinberg & Jason B. Myers, *Lurking in the Shadows: The Hidden Issues of the Securities and Exchange Commission’s Regulation FD*, 27 J. CORP. L. 173, 173-74 (2002).

²⁴⁶ See William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness*, 54 EMORY L.J. 843 (2005).

getting advance information on corporate earnings ahead of the rest of the market.”²⁴⁷

Of course, a company insider who buys or sells an issuer’s own securities on the basis of material nonpublic information may be liable for insider trading pursuant to the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.²⁴⁸ The same is true in certain cases where an issuer discloses material nonpublic information to a third party who then trades in the issuer’s securities.²⁴⁹

However, based on the U.S. Supreme Court’s rulings in the cases of *Chiarella v. United States* and *Dirks v. S.E.C.*, trading resulting from the selective disclosure of material nonpublic information to a market professional or other insider does not always run afoul of the insider trading laws.²⁵⁰ These cases hold that an insider does not violate Rule 10b-5 when she discloses confidential information for the benefit of her firm as opposed to her own self-interests.²⁵¹ Thus, when an insider discloses nonpublic in order to help analysts or others make more accurate forecasts, she will not be in violation of the insider trading laws as long as her motivation was to help the firm and not to provide herself with a personal benefit – the situation in most cases of selective disclosure.

The SEC felt that this jurisprudence created a gap in the regulation of insider trading and responded with the enactment of Regulation FD in October 2000.²⁵² Regulation FD does not characterize the practice of selective disclosure as fraudulent under Rule 10b-5. Rather, it was enacted pursuant to the SEC’s power to

²⁴⁷ LEVITT, *supra* note 214 at 87; *see also* Michael Schroeder & Randall Smith, *Disclosure Rule Cleared by the SEC*, WALL ST. J., Aug. 11, 2000, at C1 (quoting former SEC Chairman Arthur Levitt, who said that selective disclosure defied “the principles of integrity and fairness”).

²⁴⁸ *United States v. O’Hagan*, 521 U.S. 642 (1997).

²⁴⁹ *See Dirks v. SEC*, 463 U.S. 646 (1983).

²⁵⁰ *Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646 (1983).

²⁵¹ *See United States v. O’Hagan*, 521 U.S. 642 (1997).

²⁵² *Selective Disclosure and Insider Trading*, 64 Fed. Reg. 72,590-72,592.

regulate the disclosure practices of reporting companies.²⁵³ The Regulation is lengthy but provides in pertinent part that:

Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any [enumerated] person . . . the issuer shall make public disclosure of that information . . . (1) simultaneously, in the case of an intentional disclosure; and (2) promptly, in the case of a non-intentional disclosure.²⁵⁴

As described by former SEC Chair Arthur Levitt, “[t]he intent of Reg FD is really quite simple. If a company wishes to pass on market-moving information, it must share the news with everyone at the same time.”²⁵⁵

Though the basic requirements of Regulation FD are fairly straightforward, several aspects warrant closer examination. First, the term “issuer” is defined to include all reporting companies as well as companies that have a class of securities registered under Section 12 of the Exchange Act.²⁵⁶ This definition excludes foreign private issuers and foreign governments. When Regulation FD refers to “any person acting on [the issuer’s] behalf,” this category is defined as “any senior official of the issuer, or any other officer, employee, or agent of an issuer who regularly communicates” with certain enumerated persons.²⁵⁷ This category excludes “an officer, director, employee, or agent of an issuer who discloses material nonpublic information in breach of a duty of trust or confidence to an issuer.”²⁵⁸

In addition, as indicated above, Regulation FD only applies when information is selectively disclosed to certain enumerated persons. From the SEC’s perspective, these persons are “those

²⁵³ Securities Exchange Act of 1934, Sec. 13(a).

²⁵⁴ 17 C.F.R. § 243.101(b).

²⁵⁵ LEVITT, *supra* note 214 at 88.

²⁵⁶ 17 C.F.R. § 243.101.

²⁵⁷ 17 C.F.R. § 243.101.

²⁵⁸ 17 C.F.R. § 243.101.

who would reasonably be expected to trade securities on the basis of the information or provide others with advice about securities trading.”²⁵⁹ They include: (1) brokers or dealers, or their associates; (2) investment advisors and institutional investment managers; (3) investment companies and their affiliates; or (4) a holder of the issuer’s securities, where it is reasonably foreseeable that the holder will purchase or sell the issuer’s securities based on the information disclosed.²⁶⁰

Regulation FD specifically excludes from its coverage temporary insiders,²⁶¹ persons who expressly agree to maintain the disclosed information in confidence, credit ratings agencies,²⁶² media outlets, government agencies, and persons in the ordinary course of business, such as vendors, customers, or strategic partners. With respect to temporary insiders and individuals who agree to maintain the disclosed information in confidence, Regulation FD’s restrictions are superfluous in light of the fact that trading by those persons will generally come within the purview of the Supreme Court’s existing insider trading jurisprudence.²⁶³ Finally, and with certain caveats, the Regulation does not apply to disclosures made in connection with a registered offering of securities under the Securities Act of 1933.²⁶⁴

Failure to comply with Regulation FD subjects an issuer to a wide range of possible sanctions, including cease-and-desist orders, injunctions, and/or substantial monetary penalties.²⁶⁵ Violations do not give rise to Rule 10b-5 liability or private causes of action, but they are subject to SEC enforcement actions and investigations.²⁶⁶

²⁵⁹ Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,719 (Aug. 24, 2000).

²⁶⁰ 17 C.F.R. § 243.100(b)(1)(iii) (2005).

²⁶¹ 17 C.F.R. § 243.101. “Temporary Insider” is defined as a “person who owes a duty of trust or confidence to the issuer.”

²⁶² 17 C.F.R. § 243.101. With respect to credit rating agencies, the exception applies provided that the information is disclosed solely for the purpose of developing a credit rating and the entity’s ratings are publicly available.

²⁶³ See *infra* text accompanying notes 48-49.

²⁶⁴ 17 C.F.R. § 243.101.

²⁶⁵ See DONNA NAGY, RICHARD M. PAINTER, AND MARGARET SACHS, SECURITIES LITIGATION AND ENFORCEMENT (2d ed. 2008).

²⁶⁶ *Id.*

b. *Regulation FD and Board-Shareholder Negotiations.*

In the context of private negotiations between boards and shareholders, Regulations FD's disclosure requirements have the potential to serve as a significant roadblock. As discussed above, productive negotiations contemplate at least a two-sided exchange of information. Access to inside company information is often a crucial requirement for shareholders to be able to effectively monitor board behavior or for boards to be able to convince shareholders that formal confrontation is unnecessary.²⁶⁷ For example, boards may also wish to disclose confidential information during shareholder negotiations in an attempt to preempt litigation or a proxy contest.

However, in many situations where a board may be comfortable sharing confidential information as part of private negotiations, it may nonetheless be unwilling to publicly disclose the same information out of a concern that such disclosure would impair corporate interests. As indicated in the context of negotiations over executive compensation, much of the information that will enable boards and shareholders to have a meaningful dialogue is highly competitive and confidential information. Yet, a board may be forced to refrain from sharing this type of material with an institution due to the risk of a Regulation FD investigation or enforcement action. Viewed in this light Regulation, FD can be seen to interfere with the exercise of a board's business judgment as to the best way to interact with an activist institution – something traditionally left to the law of the state of incorporation.²⁶⁸

The chilling effect of Regulation FD has already been observed in practice. As research from the Yale School of Management has shown, corporate attorneys expressly advise director clients who wish to speak with shareholders in informal private settings of the need to limit the scope of their communications in accordance with Regulation FD's

²⁶⁷ Frederick Tung, *Leverage in the Boardroom: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. __ (forthcoming 2009).

²⁶⁸ See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 309 (1971).

parameters.²⁶⁹ This advice includes the option of foregoing private communications altogether due to the risk of SEC enforcement activities, or to participate in only cursory discussions.²⁷⁰ Many companies thus refuse to disclose any information that could be construed as material and non-public, while others will solely participate in “listen-only” sessions when meeting informally with shareholders.²⁷¹ According to one attorney, “executives . . . have to make sure they don’t say anything that could move the stock.”²⁷² The types of information that companies have stated they will not disclose to shareholders based on Regulation FD include financial performance data for the present quarter, internal financial projections, internal strategic plans, significant undisclosed contracts, business development opportunities, and expectations regarding future dividend payments or stock repurchase programs.²⁷³ For those boards that wish to conduct private communications with shareholders despite the litigation risks posed by Regulation FD, the corresponding transaction costs necessarily rise due to the need for tailored regulatory compliance programs and the presence of counsel whenever meeting with shareholders.²⁷⁴

The foregoing scenarios reveal a source of tension among several of the SEC’s own stated policy goals. On the one hand, several SEC Commissioners have spoken forcefully in favor of rules and regulations that would promote more robust interaction between shareholders and directors.²⁷⁵ Proposed SEC rules further

²⁶⁹ Davis, *supra* note 2.

²⁷⁰ *See id.*

²⁷¹ *See id.* (quoting one corporate insider as saying, “Our discussions with shareholders concerning corporate governance do not touch on financial or earnings metrics. We simply do not discuss any material non-public information during such communications. . . .” Other insiders stated that they will participate solely in “listen only” modes when engaged in informal discussions with shareholders).

²⁷² *See id.* (quoting Gary Brown, head of the corporate law department at Baker, Donelson, Bearman, Caldwell & Berkowitz).

²⁷³ *See id.*

²⁷⁴ *See id.*

²⁷⁵ *See Dealbook*, “S.E.C. Commissioner Backs ‘Say on Pay’,” Feb. 19, 2009, available at <http://dealbook.blogs.nytimes.com/2009/02/19/sec-commissioner-backs-say-on-pay/>; Remarks of SEC Commissioner Elisse B. Walter, “Corporate Governance – A Master Class 2009,” PLI, Feb. 18, 2009; Remarks of SEC Commissioner Luis A. Aguilar at “The SEC Speaks in 2009,” Washington, D.C. (Feb. 6, 2009) (on file with author).

demonstrate that the Commission is committed to encouraging greater levels of informal corporate communication.²⁷⁶ However, by expressly limiting the quality of information that firms will be able to share with shareholders in light of the enforcement risks presented by Regulation FD, the SEC's own regulations could very well be standing in the way of realizing the Commission's hopes for greater transparency within firms. Put differently, Regulation FD poses the very real threat of interfering with the business judgment of directors who might otherwise desire to communicate more freely and openly with their shareholders.

The SEC has several possible responses. First, the Commission might argue that many pieces of information exchanged during negotiations will be focused solely on governance procedures and thus would not be considered non-public or material for purposes of Regulation FD.²⁷⁷ This is not a satisfactory response because of the difficulty boards will face in making a qualitative assessment of information *ex ante* when asked to engage in a dialogue with shareholders.²⁷⁸ Despite the subjective intent of the parties, it will be hard to remain confident that a topic is purely outside of Regulation FD's scope if items such as earnings reports or forecasts are discussed.²⁷⁹ Indeed, as mentioned above, when those types of information are discussed many corporate attorneys advise their director clients to end negotiations in light of Regulation FD concerns.

Another possible response concerns a potential safe-harbor within Regulation FD itself. Regulation FD provides that its disclosure requirements are not triggered if the party who receives nonpublic material information agrees to maintain any private disclosures in confidence and to refrain from trading on the basis of the information.²⁸⁰ However, this option too is unsatisfactory in the context of negotiations. Many institutions will most likely be reluctant to agree to confidentiality terms given that they could open the door for an insider trading investigation or prosecution

²⁷⁶ See *supra* text accompanying note 192.

²⁷⁷ 17 C.F.R. § 243.101.

²⁷⁸ National Association of Corporate Directors, *Framework and Tools for Improving Board-Shareowner Communications* (2004).

²⁷⁹ *Id.*

²⁸⁰ 17 C.F.R. § 243.101.

under the so-called “misappropriation theory.”²⁸¹ This theory emerged in the Supreme Court case of *United States v. O’Hagan* in 1997. *O’Hagan* holds that “a person violates . . . Rule 10b-5 . . . when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.”²⁸² The key for 10b-5 liability, according to the Court, is when the fiduciary “pretends loyalty to the principal while secretly converting the principal’s information for personal gain.”²⁸³

Though the Court did not define fiduciary in the context of the misappropriation theory, the SEC promulgated Rule 10b5-2 as guidance on this issue. According to Rule 10b5-2, a person trading or disclosing material nonpublic information breaches a “fiduciary-like” duty when she has “agreed to maintain [the] information in confidence.”²⁸⁴ Thus, in the event that an institutional investor agrees to maintain information in confidence during the course of negotiations with a board, that institution would become a “fiduciary” under Rule 10b5-2. This in turn would set the institution up for a possible insider trading prosecution should it subsequently trade in the issuers’ stock, regardless of whether the trading was based on the information gleaned during negotiations.

To address these issues, the SEC could provide additional interpretive or enforcement guidance concerning the scope of Regulation FD and its relationship to negotiations between firms and shareholders on governance matters. Of course, any guidance that is not sufficiently tailored to the issues that arise during private negotiations runs the risk of presenting the same predictive difficulties faced by firms trying to determine Regulation FD’s application *ex ante*. Another possible solution would be to create an additional safe-harbor with Regulation FD that would expressly carve out a space for boards to negotiation with institutional investors on matters of governance and strategy, an option recommended by Stephen Davis at the Yale School of Management, or even to eliminate Regulation FD altogether.²⁸⁵

²⁸¹ *United States v. O’Hagan*, 521 U.S. 642 (1997).

²⁸² *Id.*

²⁸³ *Id.*

²⁸⁴ SEC Rule 10b5-2(1).

²⁸⁵ *See* Davis, *supra* note 2.

However, either option would require an internal balancing of policy concerns within the SEC. The Commission would need to balance its desire for greater levels of corporate transparency against its insider trading enforcement goals and policies. Additional legislative changes may further be required in order to address the complications presented by the *O'Hagan* misappropriation theory.

V. A MODEL OF NEGOTIATIONS IN GOVERNANCE: "SAY ON PAY"

Based on this Article's discussion of the governance and regulatory implications of private board-shareholder negotiations, it is perhaps useful to provide a detailed illustration of how specific issues frequently generate an increasing focus on board-shareholder dialogue. One of the most visible examples in this regard occurs in the debate over executive compensation.

Even before the financial crisis that began in the fall of 2008, shareholders at many U.S. companies advocated for reforms in executive compensation.²⁸⁶ Of the various reforms discussed, one in particular received significant attention: shareholder advisory votes on executive compensation, commonly referred to as "say on pay" votes.²⁸⁷ "Say on pay" has received the support of the Council for Institutional Investors, the Interfaith Center for Corporate Responsibility, RiskMetrics Group (formerly Institutional Shareholder Services), and other policy groups.²⁸⁸ In its most basic form, the practice enables shareholders to democratically express their approval or disapproval of the executive remuneration packages at their firms. Though "say on pay" votes are nonbinding on the board, they place considerable pressure on companies to reform their compensation policies and

²⁸⁶ Eric Dash, *Compensation Experts Offer Ways to Help Curb Executive Salaries*, N.Y. TIMES, Dec. 30, 2006.

²⁸⁷ Gretchen Morgenson, *Verizon Shareholders To Vote on Pay of Top Executives*, N.Y. TIMES, Nov. 2, 2007; Edward Labaton & Ethan Wohl, *Selective 'Say-on-Pay' the Best Remedy*, EXECUTIVE COUNSEL (Nov./Dec. 2008); Keith L. Johnson & Daniel Summerfield, *Shareholder Say on Pay – Ten Points of Confusion*, Shareholder Forum Program on Reconsidering Say on Pay Proposals, Columbia School of Journalism (Oct. 14, 2008) (on file with author); Davis, *supra* note 210.

²⁸⁸ *See id.*

can even lay the groundwork for litigation.²⁸⁹ Moreover, as discussed previously, the pressures to heed a shareholders' warning about compensation have grown as an increasing number of firms adopt majority voting policies for director elections. These policies make it easier for activists to remove directors who, in their opinion, underperform or fail to act in the best interest of the company.

Though still relatively new in the United States, "say on pay" has been a fixture at corporations in the United Kingdom – which, in 2003, became the first country to legally require shareholder advisory votes on compensation.²⁹⁰ Recent empirical work by scholars at the Yale School of Management analyzed the evolution of "say on pay" in the United Kingdom and concluded that it has led to an increase in the quantity and quality of dialogue between directors and institutional investors.²⁹¹ In addition to discussions about executive pay, large shareholders are now frequently asked to comment privately on board appointments and other routine governance matters.²⁹² The study further found that "say on pay" has triggered increased responsiveness by boards to shareholder concerns, slower executive pay growth, and more frequent and well-developed remuneration policies that more closely tie pay with company performance.²⁹³ U.K. firms now regularly initiate direct outreach to shareholders on an individual basis, hold annual invitation-only meetings with their largest institutional investors, or use a combination of these methods.²⁹⁴

The rise in direct board-shareholder dialogue was an almost overnight phenomenon in the U.K. after GlaxoSmithKline (GSK)

²⁸⁹ See Larry Ribstein, *The SEC: From Fraud Accessory to Quack Corporate Governance*, IDEOBLOG (Feb. 19, 2009).

²⁹⁰ Stephen Davis, *Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable*, Millstein Center for Corporate Governance, Yale School of Management (2007). Subsequent to the UK's adoption of mandatory "say on pay," the countries of Australia and Sweden followed suit. *Id.*

²⁹¹ *Id.*

²⁹² THE ECONOMIST, *Shareholder Democracy: Battling for Corporate America*, March 11, 2006.

²⁹³ Stephen Davis, *Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable*, Millstein Center for Corporate Governance, Yale School of Management (2007).

²⁹⁴ Davis, *supra* note 2.

board's suffered an unexpected defeat in 2003.²⁹⁵ GSK was the first company to put its proposed executive compensation package up for a shareholder advisory vote in accordance with the U.K.'s "say on pay" regulations. The package failed, with 50.7% of shareholders voting against it.²⁹⁶ Though admittedly non-binding on the board, the result triggered widespread negative publicity against the firm and embarrassment for its directors.²⁹⁷ Since that time, the firm now holds two annual roundtable meetings with approximately a dozen institutional investors in both the U.K. and the U.S. to discuss executive compensation.²⁹⁸ This example has led other firms in the U.K. to use negotiations to resolve shareholder concerns over executive pay prior to a "say on pay" vote in order to spare their boards from the public embarrassment that would result from a defeat.²⁹⁹

According to the Association of British Insurers, the level of private communication between boards and shareholders in the UK tripled after GSK's defeat.³⁰⁰ Such communication ranges from phone conversations to multiple high-level, in person meetings between institutional investors and directors.³⁰¹ In most cases, the negotiations result in boards changing their compensation plans in ways that more closely link performance with pay.³⁰²

The increasing levels of communication in the U.K. have also led to fewer formal confrontations between boards and shareholders. As I indicated in Part I, activists in the U.S. frequently feel compelled to submit formal shareholder proposals under Rule 14a-8 before trying direct negotiations with the target

²⁹⁵ See BBC, *Glaxo Defeated by Shareholders*, May 19, 2003, available at <http://news.bbc.co.uk/2/hi/business/3038381.stm>; Stephen Davis & Jon Lukomnik, *The Spring's Big Fight: Say on Pay*, COMPLIANCE WEEK, Jan. 17, 2007.

²⁹⁶ See BBC, *Glaxo Defeated by Shareholders*, May 19, 2003, available at <http://news.bbc.co.uk/2/hi/business/3038381.stm>.

²⁹⁷ See *id.*; Stephen Davis, *Talking Governance: Board-Shareowner Communications on Executive Compensation*, Millstein Center for Corporate Governance, Yale School of Management (2008).

²⁹⁸ Davis, *supra* note 210.

²⁹⁹ See *id.*

³⁰⁰ *Id.*

³⁰¹ See *id.*

³⁰² See *id.*

board. These proposals, however, may result in the board taking on a defensive posture that actually chills private dialogue.³⁰³ By contrast, funds in the U.K. now consider formal shareholder proposals as a last resort when seeking to stimulate private negotiations. Instead, the recurring, market-wide nature of the U.K.'s "say on pay" requirements has led to sustained dialogue rather than "shotgun exchanges driven by dissent or crisis."³⁰⁴ This has led many institutional investors in the U.K. to devote specific departments and personnel to board-shareholder negotiations.³⁰⁵

Negotiations may also help to resolve intra-board disputes. For example, members of firm compensation committees can use information gleaned from meetings with shareholders if they are asked to explain or defend themselves to other directors who question why changes were made to pay packages.³⁰⁶ In other words, by using the threat of defeat in a "say on pay" vote as leverage, compensation committee members will likely face less opposition from other directors who might initially challenge modifications to remuneration policy.

The rising levels of informal communications between firms and shareholders stemming from the introduction of "say on pay" has also caught the attention of regulators and legislators in the U.K., who now cite the measure as something that gives British markets a competitive advantage in attracting capital.³⁰⁷ The United Kingdom Department of Trade and Industry, for example, stated that "say on pay" has had the effect of "enhancing the competitiveness of the UK economy" through "better planning by corporations" and "better dialogue with investors."³⁰⁸ This sentiment was echoed by authorities at the London Stock Exchange, as well as by four of the world's largest funds who

³⁰³ Lisa Fairfax, *Shareholder Proposals and Communication*, CONGLOMERATE (posted April 21, 2009) (commenting on the sentiment felt by a corporate secretary).

³⁰⁴ Davis, *supra* note 210.

³⁰⁵ *Id.*

³⁰⁶ *Id.*

³⁰⁷ *Id.*

³⁰⁸ *Id.*

wrote to the SEC in favor of mandatory “say on pay” votes as a way to improve the attraction of U.S. markets to foreign capital.³⁰⁹

The fact that “say on pay” in the United Kingdom has led to more frequent and robust board-shareholder dialogue is noteworthy not only for its description of the practical effects of private negotiations, but also because it may signal upcoming developments in the United States. Even before the recent financial crisis, “say on pay” resolutions were emerging on the annual proxy statements of U.S. companies with growing regularity. Approximately 70 say-on-pay proposals were submitted to public companies during the 2008 proxy season.³¹⁰ These resolutions were supported by an average of 42 percent of votes, with 10 receiving majority support.³¹¹ In the 2009 proxy season, over 100 say-on-pay proposals were submitted to U.S. companies.³¹²

“Say on pay” has received even greater attention now that regulators have started shaping their responses to the recent economic crisis. As part of the American Recovery and Reinvestment Act of 2009, enacted on February 17, 2009 and commonly referred to as the “stimulus bill,” all institutions that receive government financial assistance under the bill must give their shareholders a say-on-pay advisory vote on executive compensation during all periods in which the obligations arising from such assistance remain outstanding.³¹³ This means that in its annual proxy statement, each institution receiving stimulus funds must provide a separate non-binding shareholder vote to approve the compensation of the institution’s executives as disclosed pursuant to the SEC’s compensation disclosure rules.³¹⁴ The disclosure must include items such as a compensation discussion

³⁰⁹ *Id.*

³¹⁰ Harvard Law School Corp. Gov. Blog, ‘Say on Pay’ Now a Reality for TARP Participants (on file with author).

³¹¹ *See id.*

³¹² *See id.*

³¹³ *See* Marketwatch, *SEC OK’s Proposal to Give Investors More Say on TARP Pay*, July 1, 2009; SEC Rule Release No. 34-60218 (July 1, 2009), available at <http://www.sec.gov/rules/proposed/2009/34-60218.pdf>.

³¹⁴ SEC Rule Release No. 34-60218 (July 1, 2009), available at <http://www.sec.gov/rules/proposed/2009/34-60218.pdf>.

and analysis, compensation tables, and a narrative description of the compensation packages.³¹⁵

These requirements build on public comments made by SEC Chair Mary Schapiro and several SEC Commissioners who all have encouraged companies to voluntarily adopt “say on pay” provisions in light of the financial crisis.³¹⁶ Moreover, as the experience in the U.K. reveals, once shareholders are required by law to vote on executive compensation, their interest in engaging boards on other matters is also likely to awaken.³¹⁷

CONCLUSION

In the ever-evolving landscape of corporate governance, the continuing trend toward giving shareholders greater power and voice within firms now enables them to rely on methods of activism beyond the traditional means of shareholder proposals, proxy contests, director elections, and litigation. Specifically, as a corollary to the additional leverage provided by majority voting and other developments, more and more institutional investors are using private negotiations with management to effectuate significant changes in firm governance and strategy.

There are several reasons for this. Once shareholders and boards start engaging in negotiations, the process has proven highly effective in resolving the issues that prompted the engagement in the first place. Further, the resulting dialogue frequently generates several unique benefits to both sides that often make negotiations more desirable than other forms of interaction. For one, private negotiations will often be the most cost-effective option available. Meetings or telephone calls with a target company CEO cost considerably less than initiating a proxy solicitation campaign or litigation. From the perspective of companies targeted by activism, they too may experience cost savings in that private negotiations often lead to withdrawn shareholder proposals – thereby obviating the need to launch a

³¹⁵ *Id.*

³¹⁶ Dealbook, *S.E.C. Commissioner Backs ‘Say on Pay’*, Feb. 19, 2009, available at <http://dealbook.blogs.nytimes.com/2009/02/19/sec-commissioner-backs-say-on-pay/>; Remarks of SEC Commissioner Elisse B. Walter, “Corporate Governance – A Master Class 2009,” PLI, Feb. 18, 2009 (on file with author).

³¹⁷ See Davis, *supra* note 210.

proxy solicitation campaign of their own – or preemption of shareholder litigation.

Second, engaging in a private dialogue with a target company will generally be less hostile and less confrontational than other forms of activism, such as proxy contests, litigation, or public shaming. Of course, informal mechanisms of dialogue will only be effective if there are formal enforcement tools available. However, by beginning with private negotiations, the chance that the parties will be able to reach common ground on an issue without resort to more confrontational behavior is significantly increased. This will enable both the activists and their target companies to keep many disagreements out of the public domain, thus reducing political or media risk.

An additional key benefit of private negotiations is the increased transparency they provide for shareholders. If activists are to play a role in monitoring agency costs, they must be in a position to gain access to key inside information at firms regarding strategy and policies. Companies are more likely to disclose such information, with appropriate safeguards, in a private setting as opposed to such public forms as proxy statements and annual reports. Further, by allowing for greater transparency, regardless of whether shareholder-recommended changes are ultimately adopted by target firms, private negotiations promote the development of mutual trust between boards and shareholders.

These benefits all suggest that private negotiations provide value by filling a governance gap. However, negotiations may never realize their ultimate potential as a meaningful tool for either shareholders or boards in light of current regulatory limitations. Specifically, the restrictions on selective disclosure manifested by the SEC's Regulation FD pose a very real chance of disabling the free exchange of information that is vital to efficient and productive board-shareholder negotiations. In that sense, Regulation FD stands in direct tension with the SEC's own stated policy goal of taking action necessary to promote and encourage more frequent private dialogue between shareholders and directors.

The need to resolve this tension through additional regulatory guidance or intervention takes on particular import as

recent financial reforms appear set to trigger even more widespread discussions between directors and their largest shareholders. Thus, while private negotiations have already shown that they have considerable promise in corporate governance, now it is up to regulators to decide if they are going to stand in the way or get on board.