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ON THE ROLE AND REGULATION OF PRIVATE NEGOTIATIONS IN GOVERNANCE

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I. 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

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activism as shareholder proposals, proxy contests, and litigation.[1] 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 all speak out in favor of more frequent and robust negotiations between boards and shareholders.[2]

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.[3] 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 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.

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1. *See* STEPHEN DAVIS & STEPHEN ALOGNA, YALE SCH. OF MGMT., TALKING GOVERNANCE: BOARD-SHAREOWNER COMMUNICATIONS ON EXECUTIVE COMPENSATION 5 (2008), *available at* http://millstein.som.yale.edu/2008%2012%2008%20talking%20governance%20v2%20(4).pdf; Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1042 (2007); Stuart L. Gillan & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, J. APPLIED FIN., Fall/Winter 2003, at 4, 10; Joann S. Lublin, *New Breed of Directors Reaches Out to Shareholders*, WALL ST. J., July 21, 2008, at B4; Memorandum from Martin Lipton, Steven A. Rosenblum & Karessa L. Cain, Wachtell, Lipton, Rosen & Katz, to Clients, Some Thoughts for Boards of Directors in 2009, at 6–7 (Dec. 8, 2008), *available at* http://www.wlrk.com/docs/ThoughtsforDirectors2009.pdf; STEPHEN DEANE, RISKMETRICS GROUP, BOARD-SHAREHOLDER DIALOGUE: WHY THEY'RE TALKING 3 (2009), http://www.riskmetrics.com/system/files/private/Board_Shareholder_Dialogue_0.pdf; Shannon Pettypiece & Angela Zimm, *Pfizer Will Start Meetings with Largest Investors (Update5)*, BLOOMBERG.COM, June 28, 2007, http://www.bloomberg.com/apps/news?pid=20601103&sid=ajToCiEu_dzU&refer=news.

2. *See* COUNCIL OF INSTITUTIONAL INVESTORS–NAT'L ASS'N OF CORPORATE DIRS. 8–9 (2004); Gillan & Starks, *supra* note 1, at 9–10; Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Increasing Accountability and Transparency to Investors Remarks at "The SEC Speaks in 2009" (Feb. 6, 2009), *available at* http://www.sec.gov/news/speech/2009/spch020609laa.htm; Elisse B. Walter, Comm'r, U.S. Sec. & Exch. Comm'n, Restoring Investor Trust Through Corporate Governance Remarks Before the Practicing Law Institute (Feb. 18, 2009), *available at* http://www.sec.gov/news/speech/2009/spch021809ebw.htm; S.E.C. Commissioner Backs 'Say on Pay,' http://dealbook.blogs.nytimes.com/ (Feb. 19, 2009, 06:06 EST).

3. Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1267–68 (2008).

4. *Id.* at 1307.

5. *See id.* at 1275–76, 1282.

Despite the critical importance of private negotiations to a full understanding of corporate governance issues, the legal literature has spared little time scrutinizing them.[6] This Article addresses this oversight by analyzing the governance and regulatory implications that arise when institutional investors and firms negotiate behind the scenes. It demonstrates that negotiations are effective and provide several unique benefits that will often make them a more desirable method for resolving intrafirm 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]

This Article further contends, however, that current restrictions on corporate speech—namely the SEC's Regulation FD[9]—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.[10] 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

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6. *See, e.g.*, Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 473–74 (2008) (citing Jay C. Hartzell & Laura T. Starks, *Institutional Investors and Executive Compensation*, 58 J. FIN. 2351, 2352–53 (2003)) (noting evidence that communication between firms and institutional investors leads to reform in the area of managerial pay); Robert W. Hamilton, *Corporate Governance in America 1950–2000: Major Changes but Uncertain Benefits*, 25 J. CORP. L. 349, 356–57 (2000) (discussing the ways informal communication between shareholders and portfolio corporations can influence changes in corporate governance); 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) (giving examples of institutional investors that have effected corporate governance changes by approaching management privately); Randall S. Thomas, *The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation*, 61 VAND. L. REV. 299, 302–03 (2008) (arguing that indirect pressure on boards is likely a successful way to achieve change in corporate governance). *But cf.* Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 250–51 (2001) (concluding that corporate governance activism in the form of shareholder proposals by institutional investors has not resulted in a significant positive impact on firm performance).

7. *See* DAVIS & ALOGNA, *supra* note 1, at 5, 13; 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, 1336–37 (1998); 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. DAVIS & ALOGNA, *supra* note 1, at 5–6; Lipton, Rosenblum & Cain, *supra* note 1, at 6.

9. 17 C.F.R. pt. 243 (2009).

10. *Id.* § 243.100(a).

obstacle to productive negotiations. This result is at odds with many of the SEC's own stated policy positions on the need for greater transparency and communication within firms.[11] To resolve this tension, additional regulatory 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.[12] Several regulatory reforms to emerge from the global financial crisis seem poised to generate increasing levels of private negotiations between firms and shareholders.[13]

Part II introduces this 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 III examines the effectiveness of private negotiations in leading to changes in firm policy or strategy. This part shows how 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 IV describes the unique benefits that accrue to investors and boards through the use of negotiations. Part V analyzes the impact of Regulation FD on board–shareholder dialogue. Part VI 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.[14] 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.[15] The British experience with say on pay has resulted in a dramatic increase in levels of private negotiations between boards and institutional investors, providing both parties with many of the benefits

11. *See, e.g.*, Aguilar, *supra* note 2 (arguing that regulatory reform in the current financial crisis should be directed at restoring transparency and accountability); Walter, *supra* note 2 (suggesting reforms in proxy access, disclosure rules, e-proxy, broker votes, and say on pay that are directed at increasing shareholder participation and board accountability); S.E.C. Commissioner Backs 'Say on Pay,' *supra* note 2 (reporting that the SEC supports say on pay measures that increase shareholder participation and trust).

12. *See* Anabtawi & Stout, *supra* note 3, at 1260; Aguilar, *supra* note 2; Walter, *supra* note 2; Ronald D. Orol, *SEC OK's Proposal to Give Investors More Say on TARP Pay*, MARKETWATCH, July 1, 2009, http://www.marketwatch.com/story/sec-oks-measure-to-give-investors-say-on-tarp-pay.

13. *See* Orol, *supra* note 12.

14. *See infra* note 383 and accompanying text.

15. *See infra* notes 386–396 and accompanying text.

described in this Article.[16] As say on pay 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[17]—this evidence suggests that negotiations will become an even more influential form of governance activity in United States in the years to come.

II. 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.[18] 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.[19] These meetings were the catalyst for Exxon's decision to appoint an environmentalist to its board.[20] The private engagement between boards and shareholders even received the attention of influential corporate attorney Martin 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.[21]

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.[22] Public pension funds, including CalPERS and several New York state pension funds, as well as TIAA-CREF (Teachers Insurance and Annuity Association and College Retirement Equity Fund), continue to be particularly active in using private negotiations to encourage boards to make governance changes voluntarily.[23] Though they often vary slightly in their specific approaches, these institutions typically follow at least 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

16. *See infra* notes 397–405 and accompanying text.

17. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, sec. 7001, § 111(e), 123 Stat. 115, 519–20.

18. Allen R. Myerson, *The New Activism at Fidelity*, N.Y. TIMES, Aug. 8, 1993, at F15.

19. Matthew L. Wald, *Exxon Head Seeks Environmentalist to Serve on Board*, N.Y. TIMES, May 12, 1989, at A1.

20. *Id.*

21. Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, *in* CORPORATE GOVERNANCE TODAY—AND TOMORROW: THE THOUGHTS OF SEVEN LEADING PLAYERS 11, 28 (1992).

22. *See* Kahan & Rock, *supra* note 1, at 1042.

23. *See id.*

in order to decide whether negotiations are in its best interests and likely to succeed.[24] 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.[25] Next, the institution will usually make informal overtures to the target company in order to begin a dialogue related to its concerns.[26] 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.[27]

At or around the same time, institutions will often submit a formal shareholder proposal on the issues they seek to address during the jawboning process.[28] Such proposals are filed pursuant to SEC Rule 14a-8[29] and are limited to a description that is no longer than 500 words.[30] Under the corporate law in many, if not 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.[31] 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, including private negotiations, will only be effective if there are formal enforcement mechanisms to back them up.[32] 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 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

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24. *See* Carleton, Nelson & Weisbach, *supra* note 7, at 1338.

25. *Id.* (citing Sunil Wahal, *Pension Fund Activism and Firm Performance*, 31 J. FIN. & QUANTITATIVE ANALYSIS 1 (1996)).

26. *See id.* at 1339; Hamilton, *supra* note 6, at 356–57.

27. Carleton, Nelson & Weisbach, *supra* note 7, at 1339; Hamilton, *supra* note 6, at 356–57.

28. Carleton, Nelson & Weisbach, *supra* note 7, at 1338–39.

29. 17 C.F.R. § 240.14a-8 (2009).

30. Carleton, Nelson & Weisbach, *supra* note 7, at 1338.

31. *See* Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 130 (2009) ("Shareholders have binding votes on only two things: the election of directors and ratifying fundamental corporate changes such as mergers.").

32. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 522 (1990).

the operations and objectives of the firms in which they have invested.[33] Instead, control is vested in the board of directors and those executives and managers selected by the board to oversee day-to-day operations.[34]

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.[35] In the most basic form, shareholders, as owners, elect a board of directors bound by fiduciary duties to oversee the firm on their behalf.[36] However, directors and officers selected by directors might shirk, steal, or otherwise act in ways that are contrary to the interests of shareholders.[37] 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.[38]

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; or (e) sue to enforce the fiduciary duties owed to them by management.[39]

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.[40] For one, when shareholders are widely dispersed and individually own only a small percentage of shares in a company, it simply does not make economic sense for individuals

33. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 78 (Harcourt, Brace & World, Inc. rev. ed. 1968) (1932) [hereinafter BERLE & MEANS 1968].

34. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 559 (2003).

35. See Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 781–83 (1972); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–10 (1976); Roberta Romano, *Corporate Law and Corporate Governance*, 5 INDUS. & CORP. CHANGE 277, 277–78 (1996); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 117–18 (2009) (citing ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) [hereinafter BERLE & MEANS 1932]).

36. Tung, *supra* note 35, at 118.

37. *Id.*

38. *Id.*

39. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 569 (2006); Tung, *supra* note 35, at 118.

40. *See* Anabtawi & Stout, *supra* note 3, at 1274–75; Black, *supra* note 32, at 526–29.

to spend time, money, and energy trying to invoke corporate change.[41] 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.[42] In the words of Berle and Means, "[w]hen the largest single [stockholder] interest amounts to but a fraction of one per cent—the case in several of the largest American corporations—no stockholder is in the position through his holdings alone to place important pressure upon the management."[43] Thus, the reality of widely dispersed share ownership leads to rational apathy by individual shareholders.[44]

Furthermore, state and federal 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 "allow[s] incumbent directors to use corporate funds to solicit shareholder proxy votes in support" of their positions.[45] By contrast, any individual shareholders who hope to mount a challenge must use their own personal funds in solicitation efforts.[46] Further, they must distribute a separate proxy statement describing only their candidate and successfully campaign for more votes than the slate of directors proposed by the incumbent management and described on the company's annual proxy statement.[47] This is an extremely expensive process, both in terms of time commitments and fiscal outlays.[48] Once shareholders weigh the costs of launching a proxy solicitation campaign against the chances of ultimate success, many shareholder initiatives effectively die before they are undertaken.[49] The end result is that shareholders actually contest very few board elections.[50]

Given the practical constraints on shareholder intervention and influence, general thought indicated that it made the most economic sense for dissatisfied

41. *See* BERLE & MEANS 1968, *supra* note 33, at 76 ("The normal apathy of the small stockholder is such that he will either fail to return his proxy, or will sign on the dotted line, returning his proxy to the . . . corporation.").

42. *See* ROBERT CHARLES CLARK, CORPORATE LAW § 9.5.2 (1986); Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1231 (2008).

43. BERLE & MEANS 1968, *supra* note 33, at 78.

44. *See* CLARK, *supra* note 42, § 9.5.2.

45. Anabtawi & Stout, *supra* note 3, at 1275 (citing BERLE & MEANS 1968, *supra* note 33, at 76).

46. *See* BERLE & MEANS 1968, *supra* note 33, at 76; *see also* Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 686–89 (2007) (discussing the complexities involved in gaining one's own proxy).

47. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 688–89 (2007). *See generally* BERLE & MEANS 1968, *supra* note 33, at 76 (describing the process for electing management).

48. *See* Bebchuk, *supra* note 47, at 688.

49. *See id.* at 693.

50. *See id.* at 685. For example, Bebchuk describes in his article how from 1996 to 2005, incumbents faced rival director nominees in only 118 companies—about twelve companies per year. *Id.* Furthermore, only twenty-four of the companies had a market value in excess of $200 million. *Id.* at 686. Only eight challengers were successful in challenging the incumbents of those companies. *Id.* at 687.

shareholders to voice their opinions through their feet.[51] That is, under the so-called "Wall Street Rule," shareholders who disagree 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.[52] 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,[53] forms and manner of executive compensation,[54] the market for corporate control,[55] the separation of economic rights from voting rights within firms,[56] the use of independent directors,[57] the proper understanding of fiduciary duties,[58] and the role of private lenders.[59]

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51. *See* Thompson & Edelman, *supra* note 31, at 130.

52. *See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 462 (1991); Thompson & Edelman, *supra* note 31, at 130.

53. *See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 923 (1999); April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275, 300 (1998).

54. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION, at x (2004) ("By providing a full account of how and why boards have failed to serve their critical role in the executive compensation area, we hope to contribute to efforts to improve compensation practices and corporate governance more generally."); Fried, *supra* note 6, at 455 (suggesting that firms use a "hands-off" option for dealing with issues of executive compensation).

55. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 4 (1991) ("Managers may do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they had investors' interests at heart.").

56. *See, e.g.*, Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 628–29 (2008); 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. 343, 344–45 (2007); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815 (2006).

57. *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) ("In the United States, independent boards have become common for larger corporations . . . and these boards do seem to be more activist.").

58. *See, e.g.*, Stephen M. Bainbridge, Star Lopez & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 562 (2008) (discussing the duties of good faith and oversight in relation to director accountability); Claire A. Hill & Brett H. McDonnell, Disney, *Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 834–35 (2007) (suggesting that holding directors liable for the duty of good faith may influence director conduct); Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. (forthcoming 2009) (manuscript at 5), *available at* http://ssrn.com/abstract=1352595 ("It is dangerous and costly to assume that fiduciary duties function well in the corporate context.").

59. *See* Tung, *supra* note 35, at 122.

Arguably, the one alternative to receive the most attention in legal literature concerns the roles and behavior of institutional investors.[60] As indicated by Berle and Means, 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.[61] This view no longer reflects the current market.[62] 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.[63] 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.[64] Institutions can now use their ownership of large holdings to work for changes within firms through corporate elections and other means.[65]

B. The Emergence of Institutional Investors

Beginning in the early 1990s, several scholars began to explore the possibility that institutional investors could solve the rational apathy problem and practical difficulties that result from widely diffused share ownership.[66] The basic thought was that institutional investors, which typically hold much larger percentages of stock than individual investors, could use their voting power,

60. *See, e.g.*, Anabtawi & Stout, *supra* note 3, at 1275 ("[I]nstitutional investors can take far larger positions in particular companies than most individual investors ever could."); Black, *supra* note 32, at 523–24 ("Institutional investors have grown large enough so that a limited number of institutions own a sizeable percentage of the shares of most public companies."); Rock, *supra* note 52, at 449–50 ("Over the last five years, shareholder proposals, particularly proposals by institutional shareholders, have received substantial shareholder support . . . ."); Romano, *supra* note 6, at 175 (discussing the increasing influence of institutional investors); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 807 (2007) (discussing the "increasing clout" of institutional investors).

61. BERLE & MEANS 1968, *supra* note 33, at 78 ("When the largest single [stockholder's] interest amounts to but a fraction of one per cent—the case in several of the largest American corporations—no stockholder is in the position through his holdings alone to place important pressure upon the management . . . .").

62. *See* Black, *supra* note 32, at 529–30.

63. *See* Anabtawi & Stout, *supra* note 3, at 1275–77.

64. *See id.* at 1276.

65. *See id.*

66. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 819 (1992) ("[I]nstitutional voice can improve corporate performance"); Black, *supra* note 32, at 608 (stating that, due to the rise of institutional investors, shareholder "apathy may not be rational after all"); Rock, *supra* note 52, at 448 ("As shareholdings become concentrated in fewer and more sophisticated hands, it is tempting to conclude that shareholders will finally be able to overcome one of the central problems that has preoccupied corporate law for decades: the problem of collective action by shareholders.").

expertise, and resources to ensure that the incentives of directors and managers are aligned with the interests of the company's shareholders.[67]

The first institutions to receive attention were mutual funds and pension funds. These entities "aggregate the savings of millions of individuals into enormous investment portfolios that buy stock" in a broad range of public companies.[68] 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 two-thirds of all outstanding shares in the U.S. equities market.[69] Through their large holdings, institutional investors are thought to be able to overcome the rational apathy problem presented by diffuse individual shareholders.[70] 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."[71]

But size and resources only go so far in explaining why institutions are well-poised to influence corporate governance and strategy. Along with the increased holdings of institutions, corporate law has evolved to give institutions more tools by which 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.[72] Prior to this amendment, "the SEC had interpreted the phrase 'proxy solicitation' to include any communication 'reasonably calculated' to influence another shareholder's vote."[73] 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.[74] To overcome this obstacle, the 1992 amendments "exempt[ed] from the definition of 'proxy solicitation' most shareholder communications not actually accompanied by a formal proxy solicitation."[75]

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

67. *See* Black, *supra* note 32, at 523–24; Rock, *supra* note 52, at 505.

68. Anabtawi & Stout, *supra* note 3, at 1275.

69. *See id.* (citing JEFFREY D. BAUMAN ET AL., CORPORATIONS: LAW AND POLICY 509 (6th ed. 2007)).

70. Black, *supra* note 32, at 608.

71. *Id.* at 574.

72. *See* Briggs, *supra* note 46, at 686–89.

73. Anabtawi & Stout, *supra* note 3, at 1276; *see also* 17 C.F.R. § 240.14a-1(k)(l)(iii) (1991) ("The terms 'solicit' and 'solicitation' include . . . [t]he furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.").

74. *See* Anabtawi & Stout, *supra* note 3, at 1276.

75. *Id.* at 1276–77.

solicitations.[76] Such developments within the proxy structure made it feasible for institutional investors to discuss with each other their views on governance and strategy.[77] Based on the decisions reached during these discussions, they would then be able to combine their holdings to vote a larger percentage of total shares in a joint effort.[78]

Coordination among institutions has been further aided by the rise in popularity of shareholder advisory services.[79] These firms, best exemplified by the activities of RiskMetrics Group (who acquired Institutional Shareholder Services (ISS) in 2007),[80] provide mutual and pension funds with advice and recommendations on how they should vote the proxies held in connection with their portfolios.[81] Such recommendations often concern director elections, antitakeover devices, and other governance matters.[82] When shareholder advisory services like RiskMetrics coordinate the voting activity of a large group of institutions, the effect is essentially the formation of a substantial "voting block controlled, as a practical matter, by the advisory service itself," which is similar to the way in which the 1992 amendments to the federal proxy regulations enabled institutions to form large voting blocks.[83] 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]."[84]

C. *Leverage for Negotiations*

With such developments as the 1992 proxy amendments and the increasing popularity of shareholder advisory services, many institutions soon realized that they now possessed powerful tools for effectuating changes in the policies or strategies of targeted firms. For example, beginning in the mid-1990s, CalPERS became one of the most visible institutions to play an openly activist role, often being described as a "leader among activist institutions."[85] Through its use of shareholder proposals and proxy fights, CalPERS began to target

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76. *Id.* at 1277.
77. *See id.*
78. *Id.*
79. *Id.*
80. *Id. See generally* RiskMetrics Group, Company History, http://www.riskmetrics.com/history (last visited Nov. 12, 2009) (describing the history and development of the RiskMetrics Group).
81. Anabtawi & Stout, *supra* note 3, at 1277.
82. *Id.*
83. *Id.*
84. *Id.* at 1278.
85. Choi & Fisch, *supra* note 7, at 315.

"underperforming companies with poor governance practices" and then used its influence to improve performance.[86]

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.[87] 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.[88] Some institutions may also prefer to keep their activism out of the public domain for political reasons.[89]

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.[90] 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.[91] 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.[92] 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.[93]

Of course, even if boards are willing to engage in negotiations, the question remains whether the practice will be as effective as more formal methods of activism. This is of threshold importance for activist institutions since their stated goal is generally to effectuate desired changes in governance matters or business strategy.[94]

III. 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

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86. *Id.* at 315–16.

87. *See* Bebchuk, *supra* note 47, at 688–89.

88. *Id.* at 690.

89. *See* Kahan & Rock, *supra* note 1, at 1057; Editorial, *Calpers and Cronyism*, WALL ST. J., Oct. 18, 2004, at A18; Jonathan Weil & Joann S. Lublin, *Gadfly Activism at Calpers Leads to Possible Ouster of President*, WALL ST. J., Dec. 1, 2004, at A1.

90. Kahan & Rock, *supra* note 1, at 1042.

91. *See* Rock, *supra* note 52, at 481–83, 505.

92. *See* Carleton, Nelson & Weisbach, *supra* note 7, at 1338.

93. *See generally* Posting of Larry Ribstein to Ideoblog, http://busmovie.typepad.com/ideoblog/2008/06/the-press-the-t.html (June 11, 2008, 11:55 CST) (discussing anticorporate bias in the media).

94. *See* Romano, *supra* note 6, at 175.

outside of traditional channels, they now have the muscle to get the ball 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.[95] Fortunately, to assist in this effort, at least one set of scholars has gained access to the behind-the-scenes communications between an activist institution and its target companies and have shared its findings.[96]

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 had been highly successful in using private negotiations to effectuate governance changes.[97] At the time the study was released in 1998, TIAA-CREF was the largest pension fund in the U.S., "hold[ing] approximately one percent of the total U.S. equity market."[98] Between the years 1992 and 1996, TIAA-CREF targeted forty-five firms for the purposes of seeking one or more 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.[99] During the jawboning process, TIAA-CREF proved highly successful in obtaining its desired changes.[100] Though it typically started proceedings with the submission of a shareholder resolution, in most cases the fund reached an agreement prior to any formal shareholder vote.[101] Once an agreement was reached, any formal proposal on the table was withdrawn before it could appear on the publicly available proxy statement.[102] Indeed, "[t]he possibility of resolving the issue privately" was likely a key factor contributing to the high rate of negotiated settlements.[103] Though the agreements that were reached often differed slightly from the formal shareholder proposals under submission, they "still effected the fundamental changes" sought by TIAA-CREF.[104]

All said, in 87% of TIAA-CREF's engagements, it successfully used private negotiations to see its desired changes implemented by the target company.[105] In the remainder of the cases, firms initially resisted its private pressure and allowed the matter to proceed to a shareholder vote.[106] Notably, the study concluded that widely held public companies, as opposed to insider-controlled firms, were generally more willing to settle matters privately.[107] This is likely

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95. *See* Carleton, Nelson & Weisbach, *supra* note 7, at 1335–36.
96. *Id.* at 1336.
97. *See id.*
98. *Id.* at 1337.
99. *Id.* at 1336.
100. *See id.* at 1340–41.
101. *Id.*
102. *Id.* at 1341.
103. *Id.*
104. *Id.* at 1343.
105. *See id.*
106. *Id.* at 1349.
107. *See id.*

due to the fact that directors in widely held firms will generally be "more concerned about their reputation with potential future shareholders" than those in 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.[108]

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 funds 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 may start 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

1. Free Riding

Mutual funds and pension funds typically maintain highly diversified portfolios, often meaning that any single fund manager will hold only 1% or less of any single company's stock in the fund portfolio.[109] Mutual funds in particular "must comply with the diversification requirements . . . of the Internal Revenue Code" if they wish to obtain significant tax benefits.[110] These requirements specify that "50% of the assets of a mutual fund are subject to the limitations that the fund may own no more than 10% of the outstanding securities of a portfolio company, and that the stock of any portfolio company may not constitute more than 5% of the value" of the fund's assets.[111] Mutual funds must further comply with the diversification requirements of the Investment Company Act[112] if they hope "to advertise themselves as 'diversified'"—viewed by most funds as industry standard.[113] The threshold maximums under this Act are the same as in the Internal Revenue Code, except that the maximums apply to 75% of a fund's holdings.[114]

Holding small stakes in individual funds presents the same rational apathy issues as the dispersed ownership of individual investors.[115] 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

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108. *Id.*

109. *See* Anabtawi & Stout, *supra* note 3, at 1278.

110. Kahan & Rock, *supra* note 1, at 1049.

111. *Id.* (citing Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 20 (1991)).

112. 15 U.S.C. § 80a-5(b) (2006).

113. Kahan & Rock, *supra* note 1, at 1049 (citing Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1474 (1991)).

114. *Id.* (citing Roe, *supra* note 111, at 19–20).

115. *See* Kahan & Rock, *supra* note 1, at 1050–53; Gillan & Starks, *supra* note 1, at 8–9.

expense of doing so while all other shareholders enjoy the benefits despite remaining on the sidelines.[116]

Free riding concerns have not stopped mutual funds 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.[117] This is due in part to economies of scale.[118] For pension funds 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 reforms, than to take on firm decisions point-by-point.[119] This is confirmed by a review of the changes sought by TIAA-CREF, which, as discussed above, are related to board diversity, confidential voting, and alterations to antitakeover measures.[120] The focus on systematic rather than strategy-specific changes is also consistent with the substantial role shareholder advisor services play in shaping institutional voting patterns.[121]

2. *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 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.[122] Still others realize that many institutions will often be unwilling to follow through with threats of formal action.[123] This is because, even with the 1992 proxy amendments, the proxy system still presents obstacles to institutional activism.[124] In addition to cost, state corporation laws often limit the ability of shareholders to call special meetings for the purpose of voting on directors.[125] Shareholders generally lack the power to present their own candidates or proposals outside of regularly scheduled shareholder meetings or action on the

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116. *See* Gillan & Starks, *supra* note 1, at 8–9.
117. *See* Kahan & Rock, *supra* note 1, at 1043.
118. Black, *supra* note 32, at 580.
119. *See id.* at 580–81; Kahan & Rock, *supra* note 1, at 1043–44.
120. *See* Carleton, Nelson & Weisbach, *supra* note 7, at 1336.
121. *See* Kahan & Rock, *supra* note 1, at 1044.
122. *See id.* at 1083–87.
123. *See id.* at 1044–45.
124. *See id.* at 1045.
125. *See, e.g.*, DEL. CODE ANN. tit. 8, § 211(d) (2001) ("Special meetings of the stockholders may be called by the board of directors or by such person or persons as may be authorized by the certificate of incorporation or by the bylaws.").

part of management.[126] Moreover, 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.[127] 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 addressed 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 be underperforming. 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.[128] Those firms that continue to ignore institutions seeking to negotiate do so at their own peril. Moreover, a group of institutions—activist hedge funds—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.

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 receiving the most votes wins an election even if he or she fails to win a majority of votes.[129] 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.[130] According to one study, "between 2006 and 2007, the percentage of Fortune 500 firms adopting some form of majority voting policy rose from 20% to more than 50%."[131] The result of majority voting is that "withheld" votes now translate into votes affirmatively

126. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 837 (2005).

127. *See* Thompson & Edelman, *supra* note 31, at 130 ("Shareholders have binding votes on only two things: the election of directors and ratifying fundamental corporate changes such as mergers.").

128. *See* DAVIS & ALOGNA, *supra* note 1, at 12.

129. Anabtawi & Stout, *supra* note 3, at 1282–83.

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

131. Anabtawi & Stout, *supra* note 3, at 1283 (citing Press Release, Claudia H. Allen, Neal, Gerber & Eisenberg LLP, Majority Voting in Director Elections—An Activist Success Story (Nov. 13, 2007), *available at* http://www.ngelaw.com/news/pubs_detail.aspx?id=777).

against a specific candidate.[132] The practical effect of this system is to provide institutions with more leverage over director elections.[133] 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.[134]

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 director elections.[135] Brokers and financial institutions hold close to 85% of securities traded on public exchanges on behalf of their investor clients.[136] A large number of those investors do not instruct their brokers on how to vote their shares.[137] Under the original language of Rule 452, brokers were allowed to vote these investors' shares on "routine" matters, which included director elections.[138] Because brokers generally 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.[139] The amendments to Rule 452, however, no longer classify director elections as routine.[140] Accordingly, the effect of the amendments will most likely be the removal of a reliable block of promanagement 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.[141] The practical result of the amendments will be especially significant for those companies that now use majority voting.[142]

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 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

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132. *Id.*

133. *Id.*

134. *See* Press Release, Claudia H. Allen, *supra* note 131; *see also* Keith L. Johnson & Daniel Summerfield, Shareholder Say on Pay—Ten Points of Confusion 3–4 (Oct. 14, 2008) (unpublished manuscript, on file with author) (describing efforts taken by companies to facilitate communication with shareholders).

135. Order Approving Proposed Rule Change to Eliminate Broker Discretionary Voting for the Election of Directors, Exchange Act Release No. 60,215, 74 Fed. Reg. 33,293, 33,300 (July 1, 2009).

136. Anabtawi & Stout, *supra* note 3, at 1282 (citing Posting of Ted Allen to Risk & Governance Blog, http://blog.riskmetrics.com/2007/05/sec_hears_testimony_on_broker.html (May 25, 2007)).

137. *Id.* (citing Allen, *supra* note 136).

138. Notice of Filing of Proposed Rule Change to Amend NYSE Rule 452, Exchange Act Release No. 59,464, 74 Fed. Reg. 9864, 9864–65 (proposed Feb. 26, 2009).

139. Anabtawi & Stout, *supra* note 3, at 1282.

140. *See* Order Approving Proposed Rule Change to Eliminate Broker Discretionary Voting for the Election of Directors, 74 Fed. Reg. at 33,296.

141. *See id.* at 33,300.

142. *See id.*

separate proxy statement describing their own candidates.[143] 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.[144] 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 is a "large accelerated filer[]" or has a market value of $700 million or greater.[145] The share ownership threshold increases to 3% for companies with market values between $75 million and $700 million, and 5% for companies with market values below $75 million.[146]

The proposed rule allows shareholders to aggregate holdings to meet the relevant minimum ownership levels.[147] Shareholders must have held their shares for at least one year[148] and must not be holding stock for the purposes of taking control of the company.[149] With respect to nominees, companies must allow shareholders to nominate at least one director but are not required to allow shareholders to nominate more than 25% of the total board composition.[150]

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 a company's charter/bylaws—from nominating a candidate for election as a director."[151] Some have opined that this provision is designed "to exclude nonvoting 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—from nominating directors.[152] 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, make it easier for large shareholders to communicate with one another

143. *See supra* notes 45–47 and accompanying text.

144. Facilitating Shareholder Director Nominations, Securities Act Release No. 9046, Exchange Act Release No. 60,089, Investment Company Act Release No. 28,765, 74 Fed. Reg. 29,024, 29,035 (proposed June 18, 2009).

145. *Id.*

146. *Id.*

147. *Id.* at 29,035, 29,053.

148. *Id.* at 29,035.

149. *Id.* at 29,072.

150. *Id.* at 29,043.

151. Press Release, U.S. Sec. & Exch. Comm'n, SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors (May 20, 2009), *available at* http://www.sec.gov/news/press/2009/2009-116.htm.

152. Posting of J.W. Verret to Conglomerate Blog, http://www.theconglomerate.org/2009/05/the-proxy-access-rule.html (May 22, 2009).

and coordinate their strategies.[153] 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.[154] 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.[155]

Taken individually or collectively, the foregoing developments present the very real chance of making it easier than ever 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 shareholders privately in an effort to enhance their credibility and authority.[156]

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.[157] Recent shareholder unrest at companies such as Home Depot, Pfizer, and UnitedHealth led these companies to open lines of communication with their shareholders.[158] To take one example, Bonnie G. Hill, Home Depot's longest-serving director, has been described as the epitome of "an emerging breed of directors who reach out to shareholders."[159] 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 address their anger.[160] This decision came after an AFL-CIO leader sent a terse letter to Ms. Hill advocating for a closer link between executive pay and corporate performance.[161] 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 tie the pay of Mr. Nardelli's successor more closely to the company's performance.[162]

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153. *See* Electronic Shareholder Forums, Exchange Act Release No. 57,172, Investment Company Act Release No. 28,124, 73 Fed. Reg. 4450, 4455 (Jan. 25, 2008) (to be codified at 17 C.F.R. pt. 240).

154. 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, 495–96 (2008).

155. *See id.* at 487. 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 campaign successfully for the resignation of Yahoo's CEO. DAVIS & ALOGNA, *supra* note 1, at 14.

156. *See* DAVIS & ALGONA, *supra* note 1, at 12.

157. Lublin, *supra* note 1.

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.*

Ms. Hill also participated in a conference call organized by several union pension funds to discuss their concerns about various governance matters at Home Depot.[163] Two months later, four Home Depot directors met with representatives of the pension funds and "proposed a larger 'town hall' to air investor concerns."[164] At the town hall, the 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 with the downturn in the housing market.[165] 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."[166]

Another company whose directors have recently started communicating directly with shareholders is Pfizer.[167] 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.[168] For the first meeting, Pfizer invited shareholders who collectively held approximately 35% of Pfizer's stock.[169] This built on Pfizer's existing informal policy of forwarding every substantive shareholder communication to the board and then sending responses.[170] Pfizer also has no restrictions that prevent directors from meeting with shareholders on their own initiative.[171]

UnitedHealth Group, Inc. has taken a similar approach and privately engages shareholders on both an "ad hoc basis, and in a separate, formal shareholder advisory committee on board nominations."[172] Other firms have held open-invitation shareholder meetings separate from the annual shareholder meeting, formed informal shareholder advisory groups, and directed that management respond to specific shareholder inquiries.[173]

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 firms, for some institutions issues remain concerning free riding by other shareholders.[174] For one specific

163. *Id.*
164. *Id.*
165. *Id.*
166. *Id.*
167. Pettypiece & Zimm, *supra* note 1.
168. *Id.*
169. *Id.*
170. *See* COUNCIL OF INSTITUTIONAL INVESTORS–NAT'L ASS'N OF CORPORATE DIRS., *supra* note 2, at 8.
171. *See id.*
172. DEANE, *supra* note 1, at 2.
173. *See* DAVIS & ALOGNA, *supra* note 1, at 6–7.
174. *See* Kahan & Rock, *supra* note 1, at 1050–54.

type of institution, however, the free riding problem faced by mutual funds and pension funds does not always present a significant obstacle to activism.[175] 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 effect substantial changes in firm governance and strategy.[176]

Unlike other types of funds, hedge funds generally do not hold highly diversified portfolios.[177] They often take large positions in a handful of firms and then use their standing as shareholders to push for aggressive wealth maximization.[178] This can entail applying public pressure to a portfolio company's board, maintaining a proxy contest to unseat incumbent management, or filing litigation against managers.[179] Furthermore, 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.[180] 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.[181] Hedge funds are also able to take advantage of the 1992 proxy amendments to form groups, described as "wolf packs," to purchase even larger percentages within chosen firms.[182]

No longer satisfied to target only small and midsize companies, in recent years hedge funds have bought positions in such storied corporations as McDonald's and Time Warner.[183] 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.'"[184]

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 recent empirical study by researchers at the London Business School who examined the ways in which the Hermes UK Focus Fund (HUKFF) targets underperforming companies and then actively engages them in private negotiations on governance

175. *Id.* at 1066.
176. *Id.* at 1062, 1067–69.
177. *Id.* at 1070.
178. *See id.* at 1069–70.
179. *Id.* at 1029.
180. *Id.* at 1027, 1069.
181. *Id.* at 1069–70.
182. Anabtawi & Stout, *supra* note 3, at 1279 (citing William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1379 (2007); Briggs, *supra* note 46, at 692).
183. *See id.* (citing Mara Der Hovanesian, *Attack of the Hungry Hedge Funds*, BUS. WK., Feb. 20, 2006, at 72).
184. *Battling for Corporate America*, ECONOMIST, Mar. 11, 2006, at 69, 69.

changes.[185] HUKFF is managed by the Hermes Group, which in turn is owned by the British Telecommunication Staff Superannuation Pension Scheme, one of the four largest pension funds in the United Kingdom.[186] HUKFF has been described as a hybrid fund, but it is similar to a U.S. hedge fund in that it addresses the problem of free riding faced by mutual funds.[187] The trustees of HUKFF believed that the fund should consist primarily of shares from a group of underperforming companies that could "be engaged more intensively" on a company-by-company, issue-by-issue basis.[188]

When it decides to engage companies, HUKFF relies primarily on private negotiations at the outset rather than the submission of shareholder proposals.[189] It applies three criteria when evaluating which portfolio funds to target.[190] It asks "whether the company is underperforming, if the fund believes it can engage the company successfully, and whether the fund expects to obtain at least 20% more value over current share price."[191] If all three factors are present, the fund will invest, make private contact with the target, and open a line of communication regarding desired changes.[192] If the target agrees to implement the requested changes, the fund will simply monitor the situation to ensure compliance.[193] If the targeted company opposes the changes, the situation becomes more confrontational.[194] At that point, the fund may choose to threaten a public press campaign or takeover attempt.[195]

Ultimately, HUKFF engaged thirty of the forty-one 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.[196] The fund never contacted banks or bondholders, but it did frequently communicate with other institutional shareholders to seek their support for its efforts.[197] However, joint undertakings with other institutions occurred in only three cases.[198]

At twenty-eight of the thirty companies targeted by HUKFF, the fund requested "substantial restructuring," such as the sale of noncore divisions or

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185. *Id.* at 71.

186. Marco Becht et al., *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund*, 22 REV. FIN. STUD. 3093, 3101–02 (2009).

187. *See id.* at 3095 & n.2, 3102.

188. *See id.* at 3102 (citing Statement of Alastair Ross Goobey, *London Business School Roundtable on Shareholder Activism in the U.K.*, J. APPLIED CORP. FIN., Spring 2006, at 8, 19).

189. *Id.* at 3096.

190. *Id.* at 3103.

191. *Id.*

192. *See id.*

193. *Id.*

194. *Id.*

195. *Id.* at 3103, 3111.

196. *Id.* at 3095–96.

197. *Id.* at 3108.

198. *Id.*

assets.[199] Primarily, through the use of direct engagement with these twenty-eight companies, it achieved a success rate of over 50%.[200] In more than half of its engagements, the fund sought increased cash payouts to shareholders or to replace the target company's CEO or chairman so that someone more inclined to adopt the fund's recommendations could be appointed.[201] These efforts were highly successful, achieving the desired result over 64% and 75% of the time, respectively.[202] Moreover, once the target firms made the changes, the study found that their share prices increased substantially—by as much as 6.6% immediately following disclosure of the change to the market.[203]

A review of HUKFF's use of negotiations to effectuate governance changes suggests that U.S. hedge funds—likewise positioned to solve the free riding problems faced by other institutional investors—could follow its example and use private negotiations to effectuate structural 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.[204] To be sure, U.S. hedge fund activism often takes the shape of public shaming campaigns aimed at a target firm.[205] In one prominent example, a hedge fund attacked the CEO of a target firm personally, saying, "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."[206] One month later the CEO resigned.[207]

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 with all hedge funds. A study by Professors Brav, Jiang, Thomas, and Partnoy reveals that U.S. hedge funds frequently rely on private negotiations with management of target companies.[208] Using data of U.S. hedge fund activity from 2001 to 2006,[209] these scholars found the following:

> [H]edge 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

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199. *Id.* at 3097.

200. *See id.* at 3111 & n.31.

201. *Id.* at 3097.

202. *Id.* at 3111–12.

203. *Id.* at 3097.

204. Kahan & Rock, *supra* note 1, at 1078.

205. Becht et al., *supra* note 186, at 3095.

206. Kahan & Rock, *supra* note 1, at 1029 (quoting *Third Point Demands that Star Gas CEO, Irik Sevin, Resigns and Returns Keys to Company Car*, PR NEWSWIRE, Feb. 14, 2005, *available at* Factiva, Doc. No. PRN0000020050214e12e00dqm) (internal quotation marks omitted).

207. Press Release, Star Gas Partners, L.P., Star Gas Partners, L.P. Announces Resignation of CEO (Mar. 7, 2005), *available at* http://www.star-gas.com/releasedetail.cfm?ReleaseID=157475.

208. *See* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1745 (2008).

209. *Id.* at 1730.

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.[210]

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. First, as Professor Bebchuck has noted, under U.S. law shareholders cannot initiate changes to a company's charter.[211] By contrast, in the U.K. shareholders may initiate changes in the basic corporate contract through a shareholder vote.[212] 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.[213] In the U.K., the default system for corporations is majority voting, making it easier for activists to unseat incumbent management.[214] Moreover, shareholders owning 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.[215] If a resolution seeking the dismissal of a director wins over 50% of the votes cast at an extraordinary meeting, the director must resign.[216] In Delaware, however, shareholders cannot call extraordinary meetings unless authorized by express provisions in their corporate charter.[217] 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.[218] 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.[219]

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.[220] Professors Anabtawi and Stout have noted that "[o]ne such troubling scenario arises when an activist becomes a formal shareholder with

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210. *Id.* at 1732.
211. *See* Bebchuck, *supra* note 126, at 844, 847–48.
212. *Id.* at 848–49.
213. *See supra* notes 129–131 and accompanying text.
214. Becht et al., *supra* note 186, at 3099.
215. *Id.*
216. *Id.*
217. *Id.* at 3101.
218. *See id.*
219. *See* Brav et al., *supra* note 208, at 1730–36.
220. *See* Anabtawi & Stout, *supra* note 3, at 1283–92. Professors Anabtawi and 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.* at 1295.

voting power while simultaneously either 'shorting' the company's shares or entering into a derivatives contract to hedge away its economic interest."[221] 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.[222]

A similar issue arises when an activist purchases securities of two companies and then takes a position adverse to one.[223] 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."[224] This scenario was well-publicized during the narrow approval of the merger between AXA, a French company, and MONY, a publicly held insurance corporation.[225] 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.[226]

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."[227] 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.[228] However, Perry was also a significant holder in King, and "had used a derivatives contract to hedge away its economic interest in the Mylan shares it had purchased."[229] Thus, Perry stood to reap a substantial profit even if Mylan overpaid in its acquisition of King.[230]

Activist hedge funds' conflicts of interest are only just starting to become fully apparent.[231] One recent empirical study found that, over a twenty month

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221. *Id.* at 1286–87. "Shorting" refers to the practice where one investor borrows stock from a brokerage firm and then sells it to a third party. Brigitte Yuille, *Short Selling*, FORBES INVESTOPEDIA, http://www.investopedia.com/university/shortselling/shortselling1.asp (last visited Nov. 13, 2009). After the investor has sold the stock, she must buy the stock on the open market to replace the borrowed stock. *Id.* 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. *Id.* If the price of the stock increases, however, the investor will suffer a loss when she purchases it at the higher price. *Id.*

222. *See* Anabtawi & Stout, *supra* note 3, at 1287.

223. *Id.*

224. Kahan & Rock, *supra* note 1, at 1071.

225. *Id.* at 1073.

226. *Id.* at 1073–74.

227. Anabtawi & Stout, *supra* note 3, at 1287.

228. *See* 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); Thompson & Edelman, *supra* note 31, at 153.

229. Anabtawi & Stout, *supra* note 3, at 1287.

230. *Id.*

231. *Cf.* Briggs, *supra* note 46, at 695 (noting that 2005 was the first year in which "hedge fund activism received widespread notice").

period, of fifty-two companies in which an activist hedge fund launched a campaign, only six cases involved what the researcher called "possibly questionable situations."[232] In those cases, the hedge fund had a clear conflict of interest due to investments in potentially adverse merger parties or derivative contracts.[233] However, as the researcher acknowledged, this figure may be underrepresentative of cases involving similar conflicts.[234] Hedge funds must disclose their interests in a 13D filing only when they acquire 5% or more of a company's securities.[235] 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."[236] As a result, when firms negotiate with hedge funds, directors and other institutions will need to remain cognizant of possible hedge fund motivations to ensure that the product of any negotiations will be in the best interests of the company and shareholders as a class.

IV. 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 that seek negotiations. The examples of Home Depot[237] and HUKFF[238] 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 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.[239] The tenth principle on the NACD's list provides that "[g]overnance structures and practices should be designed to encourage communication with shareholders" and suggests that "boards should consider ways to engage large long-term shareholders in dialogue about corporate governance issues and long-term strategy issues."[240] The NACD noted that such dialogue may occur through

232. *Id.* at 696, 701.
233. *See id.* at 701–02.
234. *See id.* at 695.
235. *Id.* at 688.
236. *Id.* at 703–04.
237. *See supra* notes 159–166 and accompanying text.
238. *See supra* notes 189–203 and accompanying text.
239. NAT'L ASS'N OF CORPORATE DIRS., KEY AGREED PRINCIPLES TO STRENGTHEN CORPORATE GOVERNANCE FOR U.S. PUBLICLY TRADED COMPANIES 5–12 (2008), *available at* https://secure.nacdonline.org/StaticContent/StaticPages/DM/NACDKeyAgreedPrinciples.pdf.
240. *Id.* at 11.

traditional channels, such as the proxy statement and annual report, but added that meetings with shareholders may also be beneficial.[241]

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.[242] 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.[243]

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 speak regularly with management at portfolio companies.[244] Several commissioners with the SEC have spoken publicly of the need for greater levels of communication between firms and shareholders.[245] 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.[246]

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.[247] For their part, hedge funds have the capability to use

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241. *Id.*

242. *See* THE ASPEN INST., LONG-TERM VALUE CREATION: GUIDING PRINCIPLES FOR CORPORATIONS AND INVESTORS (2007), *available at* http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/Aspen_Principles_with_signers_April_09.pdf (listing current subscribers to the Aspen Principles).

243. *Id.* § 2.

244. *See* Gillan & Starks, *supra* note 1, at 9–10 ("[T]he Labor Department now encourages pension funds to be active in monitoring and communicating with corporate management if such activities are likely to increase the value of the funds' holdings.").

245. *See* Aguilar, *supra* note 2; Walter, *supra* note 2.

246. COUNCIL OF INSTITUTIONAL INVESTORS–NAT'L ASS'N OF CORPORATE DIRS., *supra* note 2, at 6–7.

247. *See Strategies for Dealing with Shareholder Proposals*, CORPORATE GOVERNANCE COMMENT. (Georgeson Inc. & Latham Watkins LLP, New York, N.Y.), Dec. 2008, at 2 [hereinafter *Strategies for Dealing with Shareholder Proposals*], *available at* http://www.lw.com/upload/pubContent/_pdf/pub2408_1.pdf ("[M]any shareholder proponents are not in for a fight but want to negotiate.").

behind the scenes negotiations to enact substantial structural changes in target firms.[248] 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.[249] 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 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.[250] This is especially important for public pension funds, which typically do not have a separate budget for corporate governance activities.[251] In practice, cost savings resulting from a preference for negotiations may be influencing shareholders' allocation of resources in activist pursuits. One study of public pension funds found that these institutions either meet privately with management or engage in written correspondence 35.9% and 46.2% of the time, respectively.[252] By contrast, the same funds only sponsor shareholder proposals or solicit votes on proposals 17.5% and 15% of the time, respectively.[253]

In addition, through direct engagement, boards have also experienced cost savings in the form of an overall reduction in the number and frequency of shareholder proposals and proxy fights.[254] As the activities of TIAA-CREF and

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248. *See, e.g.*, Becht et al., *supra* note 186, at 3125–26 ("A high proportion of [HUKFF's] interventions [are] successful and result[] in substantial shareholder gains, particularly in response to restructurings and board changes.").

249. *See* Choi & Fisch, *supra* note 7, at 326–28.

250. *See* Kahan & Rock, *supra* note 1, at 1050 ("Fund managers first have to identify a company that would benefit from activism and develop a strategy for the company that would raise its share price. Then fund managers have to pressure the company's management to adopt the strategy. All of this consumes significant resources, both in-house and from hiring outside advisors.").

251. Choi & Fisch, *supra* note 7, at 348 (reporting that less than 20% of pension funds maintain a separate budget for activism).

252. *See id.* at 326.

253. *See id.* at 327.

254. *See, e.g.*, Memorandum by David A. Katz, Partner & Laura A. McIntosh, Consulting Attorney, Wachtell, Lipton, Rosen & Katz, Corporate Governance Update: Shareholders Focused on Stability in Proxy Votes 1 (Oct. 30, 2008), *available at* http://blogs.law.harvard.edu/corpgov/files/2008/11/shareholders-focused-on-stability-in-proxy-votes.pdf ("The declining number of shareholder proposals brought to a vote can be attributed to improved communication between companies and shareholders as well as, to a lesser extent, a decreased interest in pursuing (or ability to carry out) a governance agenda in the face of economic upheavals.").

CalPERS indicate, activist funds often submit proposals to alert a target company of their desire to open lines of communication.[255] These resolutions are typically withdrawn once the institution perceives a willingness on the part of the target to engage in an informal dialogue.[256] For example, in 2007, 665 shareholder proposals were submitted in the United States and just under half failed to reach a vote.[257] At least one market analyst contends that the steadily increasing number of withdrawn proposals is due partly to "frank dialogue" between activist investors and boards.[258] A leading corporate law firm has accordingly advised its 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.[259] As described in a client memorandum from Wachtell, Lipton, Rosen & Katz, "[o]ne of the primary lessons to emerge from the 2008 proxy season is that effective company–shareholder communication does make a difference."[260]

B. Transparency, Monitoring, and Dispute Resolution

For shareholders, particularly institutional investors, private negotiations also have considerable promise with respect to their ability to monitor the alignment of managerial incentives with shareholder interests.[261] 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. 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 often need to have access to inside information that describes "performance

255. *See, e.g.*, Carleton, Nelson & Weisbach, *supra* note 7, at 1339 ("With many activist funds, including TIAA-CREF, a proxy resolution is sent to the targeted firm simultaneously with the effort to initiate a dialogue.").

256. *See* CORPORATE SEC'Y & GEORGESON INC., ARMING YOURSELF AGAINST ACTIVISTS, at ii (2008), *available at* http://www.georgesonshareholder.com/usa/download/news/Corporate_Secretary_Arming-Yourself_June08.pdf ("Although the number of activist proposals has soared in the past few years, so has the number of settlements.").

257. *Id.*

258. *Id.*

259. *See* Katz & McIntosh, *supra* note 254, at 3 ("This season saw the practical impact of effective and improved communication in reducing the number of proposals that were brought to a vote and the amount of support that proposals received.").

260. *Id.* at 3.

261. "Corporate governance scholars and policymakers focus primarily on relations among firm managers and equity holders, relying on corporate law arrangements to align managers' incentives with shareholder interests . . . ." Tung, *supra* note 35, at 124.

targets and peer benchmarks."[262] Such information is generally treated as competitive information and not included in the standard compensation disclosures mandated by the SEC.[263] Without this information, however, it will be difficult for boards and shareholders to reach a consensus on pay packages.[264] Designing efficient compensation must be crafted on a firm- and individual-specific basis to provide managers with proper incentives.[265] This likely explains why, of all activists, hedge funds have been more proactive than other institutions in seeking board representation, even if only minority representation.[266] They appear driven to be able at least 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 a leading law firm recommends, engagement also does not require waiting until crises develop.[267] Communicating with shareholders throughout the year will help both boards and shareholders gain a better understanding of the issues that each side considers important.[268] This will enable boards to predict what issues might lead to confrontation.[269] Then, 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 to engage in other formal methods of confrontation in the first place.[270] Returning again to the example of executive pay, firms benefit through negotiations by obtaining feedback on remuneration policies, thereby "enabling them either to revise plans, better anticipate and perhaps preempt resistance, and/or manage risks of opposition."[271] This may even be accomplished without necessarily giving in to

262. *See* Edward Labaton & Ethan Wohl, *Selective "Say-on-Pay" the Best Remedy*, EXECUTIVE COUNS., Nov./Dec. 2008, at 18, 19 ("By design, even the best compensation reports do not allow shareholders to fully grasp the financial impact of compensation arrangements because key metrics, such as performance targets and peer benchmarks, are treated as competitive information and often are not disclosed.").

263. *Id.*

264. *See id.*

265. Posting of Larry Ribstein to Ideoblog, http://busmovie.typepad.com/ideoblog/2007/04/say_on_pay.html (Apr. 21, 2007, 07:44 CST) ("Efficient compensation must be crafted on an individual-by-individual and firm-specific basis to provide the right incentives and attract the best people.").

266. *See* Choi & Fisch, *supra* note 7, at 318–19.

267. *See, e.g.*, *Strategies for Dealing with Shareholder Proposals*, *supra* note 247, at 1 ("Timing should always be monitored carefully as the company is considering and pursuing its alternatives because its strategies may change depending on where it is in the process.").

268. *See id.* at 4.

269. *See id.*

270. *See id.* at 2–3.

271. Stephen Davis, Does "Say on Pay" Work? Lessons on Making CEO Compensation Accountable 20 (2007) (unpublished policy briefing draft, on file with the Yale School of Management), *available at* http://millstein.som.yale.edu/Policy%20Briefing%20No%201%20'Say%20on%20Pay'.pdf.

more demands than those with which the board is comfortable.[272] 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.[273] 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.[274] In the case of preempted litigation, negotiations would provide the added benefit of lessening the burdens on an already overstrained 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.[275] 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 in a proxy statement.[276] Should a board be able to convince the proposal's proponent—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.[277]

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 services play a key role in the voting activities of investors.[278] 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, they could not comply without putting corporate interests at risk.[279] By fully explaining the basis for its position to RiskMetrics, as one example, a board may be able to sway the advisory service's recommendation when the time comes for a corporate vote.

On the other hand, if a director believes a shareholder advisory service might recommend voting against her stay on the board, private and sustained outreach to key shareholders might make them less likely to simply follow the service's

272. *See Strategies for Dealing with Shareholder Proposals*, *supra* note 247, at 2.

273. *See* COUNCIL OF INSTITUTIONAL INVESTORS–NAT'L ASS'N OF CORPORATE DIRS., *supra* note 2, at 9.

274. *See Strategies for Dealing with Shareholder Proposals*, *supra* note 247, at 2.

275. *Id.* at 3.

276. *See supra* notes 254–260 and accompanying text.

277. *See Strategies for Dealing with Shareholder Proposals*, *supra* note 247, at 3–4.

278. *See supra* notes 79–84 and accompanying text.

279. *Strategies for Dealing with Shareholder Proposals*, *supra* note 247, at 3.

recommendations without question.[280] 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 and Stephen Alogna, "informed investor[s] . . . might vote 'yes' even when their proxy advisor counsels 'no.'"[281] This should be of special interest to vulnerable directors in light of data showing that at least one institutional investor votes in accordance with the recommendations of its advisory services in 75% of votes.[282]

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.[283] If a board is unwilling to engage them privately on the issues they raise, however, these shareholders may proceed to threaten a proxy battle or engage in an aggressive public relations campaign.[284] In 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.[285]

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, they may use more aggressive mechanisms, such as proxy contests, litigation, or public shaming.[286] 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.[287] 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.[288] Further, "to protect against any perception of delegation of power to investors," boards may wish to take steps that will clarify "the informational nature of the meetings with shareholders."[289] Thus, when UnitedHealth created a shareholder advisory committee on director nominations, it provided notice to all participating shareholders, stating that "'[a]ll viewpoints expressed in the advisory committee are advisory in nature only and the

280. DAVIS & ALOGNA, *supra* note 1, at 13–14 ("[One advantage of board and shareholder communication is e]nhancing the prospect that shareowners will exercise independent judgment when deciding how to cast their votes at a company's annual meeting.").

281. *Id.* at 14.

282. *Id.* at 13–14.

283. *See* CORPORATE SEC'Y & GEORGESON INC., *supra* note 256, at v.

284. *See* Anabtawi & Stout, *supra* note 3, at 1297–98.

285. CORPORATE SEC'Y & GEORGESON INC., *supra* note 256, at v.

286. Lipton, Rosenblum & Cain, *supra* note 1, at 6.

287. *See id.*

288. *See supra* notes 157–171 and accompanying text.

289. DAVIS & ALOGNA, *supra* note 1, at 13.

nominating committee and board . . . are under no obligation to follow any such viewpoints.'"[290]

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 definitively override the many benefits of negotiations, but it does suggest that the parties must go into any private engagement with their eyes open.[291] Individual shareholders will often have differing opinions about how a firm should be operated and to what end.[292] 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.[293]

For example, mutual funds often hold interests in companies where they also manage a corporate pension fund.[294] 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.[295] Indeed, mutual fund managers have indicated that their corporate pension fund business would be put at risk by simply voting against management or by expressing an interest in reforming executive compensation.[296] Mutual funds may also suffer from a conflict based on their relationships with fund beneficiaries.[297] Many are affiliated with other financial institutions, such as insurance companies.[298] Managers at these funds may fear upsetting present or future clients of the affiliated institutions through activist behavior.[299]

Public pension funds raise particular conflict concerns. For example, public pension funds are often cast in the middle of disagreements between labor and

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290. *Id.* (quoting UNITEDHEALTH GROUP, NOMINATING ADVISORY COMMITTEE DESCRIPTION 2, http://www.unitedhealthgroup.com/about/Advisory_Committee_Description.pdf (last visited Nov. 13, 2009)).

291. *See* Anabtawi, *supra* note 39, at 564 ("[S]hareholders have significant private interests, [and] it becomes apparent that they may use any incremental power conferred upon them to pursue those interests to the detriment of shareholders as a class.").

292. *See id.*

293. *See id.* at 564–65; *see also* Anabtawi & Stout, *supra* note 3, at 1284 (suggesting that fiduciary duties should be extended to interested activists who use their influence to promote a specific transaction that enables them to capture a personal economic benefit not available to shareholders generally).

294. *See* Kahan & Rock, *supra* note 1, at 1055.

295. *See id.*

296. *Id.* at 1055–56 (citing Jennifer Levitz, *Do Mutual Funds Back CEO Pay?*, WALL ST. J., Mar. 28, 2006, at C1; William Baue, *Biting the Hand That Feeds: Mutual Fund Ties to Corporate Clients Can Affect Proxy Voting*, SOCIALFUNDS, Mar. 10, 2005, http://www.socialfunds.com/news/article.cgi/article1659.html).

297. *Id.* at 1054.

298. *Id.*

299. *Id.*

management.[300] In one high profile example of this type of conflict, CalPERS actively campaigned to have the CEO of Safeway, Inc., Steven Burd, removed from his position.[301] 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.[302] 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.[303] Once Harrigan's conflict was revealed, Burd survived the attempt to remove him.[304] However, CalPERS was perceived to have been working on behalf of the union, rather than its entire class of beneficiaries, in the effort to gain the labor concessions resisted by management.[305]

Public pension funds also raise the concern that they are susceptible to undue political influence.[306] The boards of trustees of these funds are usually comprised of gubernatorial appointees, elected officials, and representatives elected by fund beneficiaries.[307] These individuals may be subject to pressures placed on them by constituents who might have diverging interests, and thus they may be tempted to pursue political rather than investment goals.[308] Accordingly, as with hedge funds, firms and other shareholders must remain cognizant of possible conflicts of interest.

V. THE PROBLEM OF REGULATION FD

Despite the many advantages that negotiations provide to shareholders seeking to engage management, proponents of the practice can overlook a significant regulatory barrier: the SEC's Regulation "Fair Disclosure" (Regulation FD).[309] This part addresses that concern.

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300. *See, e.g.*, *Calpers and Cronyism*, *supra* note 89 (observing that CalPERS's board of trustees is focused on satisfying political goals through the fund's investments); Weil & Lublin, *supra* note 89 (describing CalPERS's involvement in a labor dispute).

301. Anabtawi & Stout, *supra* note 3, at 1285–86.

302. *See id.* at 1286.

303. *Id.*

304. *Id.*

305. *See id.*

306. *See, e.g.*, *Calpers and Cronyism*, *supra* note 89 (discussing the political influences on CalPERS).

307. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 800–01 (1993).

308. Kahan & Rock, *supra* note 1, at 1059; Romano, *supra* note 307, at 801.

309. 17 C.F.R. pt. 243 (2009).

A. Background on Regulation FD

For negotiations to produce the types of benefits described in this Article, boards and shareholders 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.[310] This will likely require the use of supporting data or information—some of which may be confidential. 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.[311]

However, the degree to which directors may freely disclose information during the course of negotiations is substantially limited by the SEC's Regulation FD.[312] Regulation FD, in many circumstances, prohibits boards from disclosing material nonpublic information to shareholders if they are unwilling or unable to disclose the same information to the general public.[313] It was enacted out of concerns over the trading in securities following an issuer's selective disclosure of information to certain market participants.[314] Prior to its enactment, "issuers of publicly held securities often would selectively disclose material nonpublic information to analysts and other securities market insiders in advance of any broad public announcement."[315] Issuers selectively disclosed information typically to assist the parties in making more accurate assessments of the disclosing company's present or future performance.[316] Critics of this practice had claimed that "[s]uch 'selective disclosure' . . . put small investors at a disadvantage to the analysts, brokers, and institutional investors who were

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310. *See* CORPORATE SEC'Y & GEORGESON INC., *supra* note 256, at ii; *Strategies for Dealing with Shareholder Proposals*, *supra* note 247, at 2.

311. *See* Gillan & Starks, *supra* note 1, at 7 ("[L]arge institutional investors can convey private information that they obtain from management to other shareholders.").

312. *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7787, Exchange Act Release No. 42,259, Investment Company Act Release No. 24,209, 64 Fed. Reg. 72,590, 72,591 (proposed Dec. 28, 1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, 249) ("Regulation FD, therefore, would require that: (1) When an issuer intentionally discloses material information, it do so through public disclosure, not through selective disclosure; and (2) whenever an issuer learns that it has made a non-intentional material selective disclosure, the issuer make prompt public disclosure of that information.").

313. *Id.*

314. *Id.* at 72,591–92. *See generally* ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW, WHAT YOU CAN DO TO FIGHT BACK 87–104 (2002) (describing the history and purpose of Regulation FD).

315. Marc 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 (2002).

316. *See* William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 932–34 (2005).

routinely getting advance information on corporate earnings ahead of the rest of the market."[317]

Another significant issue in the mind of the SEC was the concern over possible analyst bias.[318] For example, there was a fear that some analysts were making overly optimistic assessments of firm prospects in order to keep those firms happy, thereby ensuring a continued stream of valuable selective disclosure of inside information.[319] Managers whose compensation or bonuses might be tied to short-term stock performance would then seemingly be presented with incentives to "bribe" analysts with selective disclosure to achieve positive recommendations.

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.[320] 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.[321]

However, based on the U.S. Supreme Court's rulings in the cases of *Chiarella v. United States*[322] and *Dirks v. SEC*,[323] 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.[324] These and other cases hold that an insider does not violate Rule 10b-5 when she discloses confidential information for the benefit of her firm and there is no breach of duty to the firm.[325] Thus, when an insider discloses nonpublic information to help analysts or others make more accurate forecasts, the insider will not violate insider trading laws as long as the motivation was to help the firm and not to obtain a personal benefit.[326]

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317. LEVITT, *supra* note 314, 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 in saying that "these practices defy the principles of integrity and fairness").

318. Stephen J. Choi, *Selective Disclosures in the Public Capital Markets*, 35 U.C. DAVIS L. REV. 533, 539–40 (2002).

319. *Id.*

320. United States v. O'Hagan, 521 U.S. 642, 651–52 (1997).

321. *See* Dirks v. SEC, 463 U.S. 646, 659–61 (1983).

322. 445 U.S. 222 (1980).

323. 463 U.S. 646 (1983).

324. *See id.* at 660 ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."); *Chiarella*, 445 U.S. at 228 ("[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so.").

325. *See O'Hagan*, 521 U.S. at 652–53.

326. *See id.*

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.[327] Regulation FD does not characterize the practice of selective disclosure as fraudulent under Rule 10b-5.[328] Rather, it was enacted pursuant to the SEC's power to "prescribe [rules] as necessary or appropriate for the proper protection of investors and to insure fair dealing."[329] Regulation FD is lengthy but provides in pertinent part the following:

> 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.[330]

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."[331]

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.[332] This definition excludes foreign private issuers and foreign governments.[333] When Regulation FD refers to "any person acting on [the issuer's] behalf,"[334] it means "any senior official of the issuer . . . , or any other officer, employee, or agent of an issuer who regularly communicates with [certain enumerated persons]."[335] This category excludes "[a]n 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."[336]

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327. *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7787, Exchange Act Release No. 42,259, Investment Company Act Release No. 24,209, 64 Fed. Reg. 72,590, 72,590–92 (proposed Dec. 28, 1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, 249); Steinberg & Myers, *supra* note 315, at 174–77.

328. 17 C.F.R. § 243.102 (2009).

329. 15 U.S.C. § 78m(a) (2006).

330. 17 C.F.R. § 243.100(a).

331. LEVITT, *supra* note 314, at 88.

332. 17 C.F.R. § 243.101(b).

333. *Id.*

334. *Id.* § 243.100(a).

335. *Id.* § 243.101(c).

336. *Id.*

In addition, as indicated above, Regulation FD only applies when information is selectively disclosed to certain enumerated persons.[337] From the SEC's perspective, these persons are "those who would reasonably be expected to trade securities on the basis of the information or provide others with advice about securities trading."[338] They include: (1) brokers or dealers, or their associates; (2) investment advisors and institutional investment managers; (3) investment companies and their affiliates; and (4) holders of the issuer's securities, where it is "reasonably foreseeable that the [holder] will purchase or sell the issuer's securities on the basis of the information."[339]

Regulation FD specifically excludes from its coverage temporary insiders,[340] "person[s] who expressly agree[] to maintain the disclosed information in confidence,"[341] credit ratings agencies,[342] media outlets, government agencies, and persons in the ordinary course of business, such as vendors, customers, or strategic partners.[343] With respect to temporary insiders and individuals who agree to maintain the disclosed information in confidence, Regulation FD's restrictions seem 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.[344] 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.[345]

Failure to comply with Regulation FD subjects an issuer to a wide range of possible sanctions, "including cease-and-desist orders, civil injunctions, and

337. *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716, 51,719 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts 240, 243, 249).

338. *Id.*

339. 17 C.F.R. § 243.100(b)(1)(i)–(iv).

340. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,720 (stating that a temporary insider is "a person who owes the issuer a duty of trust or confidence").

341. 17 C.F.R. § 243.100(b)(2)(ii).

342. *Id.* § 243.100(b)(2)(iii). With respect to credit rating agencies, the exception applies "provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available." *Id.*

343. *See id.* § 243.100(b)(2)(iv).

344. *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 652 (1997) ("The 'misappropriation theory' holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."); Dirks v. SEC, 463 U.S. 646, 660 (1983) ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."); Chiarella v. United States, 445 U.S. 222, 228 (1980) ("[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so.").

345. 17 C.F.R. § 243.100(b)(2)(iv).

monetary penalties."[346] 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.[347]

B. Regulation FD and Board–Shareholder Negotiations

In the context of private negotiations between boards and shareholders, Regulation 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 monitor board behavior effectively, or for boards to be able to convince shareholders that formal confrontation is unnecessary. For example, boards may 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 might otherwise 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.[348] As indicated in the context of negotiations over executive compensation, much of the information that would enable boards and shareholders to have a meaningful dialogue is highly competitive and confidential information.[349] 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.[350]

The chilling effect of Regulation FD has already been observed in practice.[351] 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 parameters.[352] This advice includes the option of foregoing private communications altogether due to the

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346. DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 552 (2d ed. 2008).

347. *See id.*

348. *See, e.g.*, DAVIS & ALOGNA, *supra* note 1, at 10 ("'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.'").

349. *See* Labaton & Wohl, *supra* note 262, at 19.

350. *Cf.* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 304 (1971) ("The local law of the state of incorporation will be applied to determine the right of a shareholder to participate in the administration of the affairs of the corporation . . . .").

351. *See, e.g.*, DAVIS & ALOGNA, *supra* note 1, at 10.

352. *See id.*

risk of SEC enforcement activities or to participate in only cursory discussions.[353] Many companies, therefore, refuse to disclose any information that could be construed as material and nonpublic, while others will participate solely in "listen-only" sessions when meeting informally with shareholders.[354] According to one attorney, "'executives . . . have to make sure they don't say anything that could move the stock.'"[355] At least one company has stated that it will not disclose to shareholders financial performance data for the present quarter, "internal financial projections, internal strategic plans, significant undisclosed" contracts, "business development opportunities," or expectations regarding future dividend payments or stock repurchase programs.[356] For those boards that wish to conduct private communications with shareholders despite the litigation risks posed by Regulation FD, corresponding transaction costs necessarily rise due to the need for tailored regulatory compliance programs and the presence of counsel in meetings with shareholders.[357]

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.[358] Proposed SEC rules further demonstrate that the Commission is committed to encouraging greater levels of informal corporate communication.[359] 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 focus solely on governance procedures and thus would not be considered material for purposes of Regulation FD.[360] This is not a satisfactory response because of the difficulty boards will face in making a qualitative assessment of information ex

353. *See id.*

354. *See id.* at 10–11.

355. *Id.* at 10 (quoting Melissa Klein Aguilar, *Best Practices for Talking Under Reg FD*, COMPLIANCE WK., Feb. 26, 2008).

356. *Id.* at 17.

357. *See id.* at 9–10.

358. *See supra* note 245 and accompanying text.

359. *See* COUNCIL OF INSTITUTIONAL INVESTORS–NAT'L ASS'N OF CORPORATE DIRS., *supra* note 2, at 5–7 (summarizing recent changes to rules and regulations governing corporate communications).

360. *See* 17 C.F.R. § 243.100(a) (2009).

ante when asked to engage in a dialogue with shareholders.[361] 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.[362] Indeed, as mentioned above, when those types of information are discussed, many corporate attorneys advise their director clients to limit the scope of negotiations in light of Regulation FD concerns.[363] This should not come as much of a surprise given that the SEC has historically taken an extremely strict view of what constitutes a material statement in the context of Regulation FD.[364]

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.[365] 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 under the so-called "misappropriation theory." In *United States v. O'Hagan*[366] the United States Supreme Court held 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."[367] 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."[368]

Though the Court did not define fiduciary in the context of the misappropriation theory, the SEC promulgated Rule 10b5-2 as guidance on the issue.[369] According to Rule 10b5-2, a person trading or disclosing material nonpublic information breaches a fiduciary-like duty of trust or confidence when she has "agree[d] to maintain [the] information in confidence."[370] 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

361. *Cf.* COUNCIL OF INSTITUTIONAL INVESTORS–NAT'L ASS'N OF CORPORATE DIRS., *supra* note 2, at 9 ("Shareowners should . . . inform themselves about ways to avoid inadvertently raising Regulation FD concerns.").

362. *See id.*

363. *See id.*

364. *See* SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694, 704 (S.D.N.Y. 2005) (describing how the SEC "scrutinized, at an extremely heightened level, every particular word used in the statement [alleged to have been material], including the tense of verbs and the general syntax of each sentence").

365. 17 C.F.R. § 243.100(b)(2)(i)–(ii).

366. 521 U.S. 642 (1997).

367. *Id.* at 652.

368. *Id.* at 653 (alteration in original) (internal quotation marks omitted).

369. *See* 17 C.F.R. § 240.10b5-2.

370. *Id.* § 240.10b5-2(b)(1).

fiduciary under Rule 10b5-2.[371] 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 gleamed during negotiations.[372] Companies and shareholders could attempt to work around this issue by entering into agreements whereby recipients of confidential information promise not to trade. However, such agreements are often unattractive to shareholders because they would seemingly need to be asked to sign them without learning the nature of the information to be disclosed.[373] From the SEC's perspective, and given the Commission's stated desire to protect "ordinary" investors, it would further need to address the fact that investors who sign confidentiality and no-trade agreements can still benefit from selective disclosure compared to others who do not have access to the relevant information. For example, recipients of selective disclosure can use the information to evaluate prospects of competing companies and then gain an advantage when trading in the securities of those other companies.[374]

To address these issues, the SEC should 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 within Regulation FD that would expressly carve out a space for boards to negotiate with institutional investors on matters of governance and strategy—an option recommended by Stephen Davis and Stephen Alogna[375]—or even to eliminate Regulation FD altogether. However, either option would first require

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371. *See id.*

372. *But see* SEC v. Cuban, 634 F. Supp. 2d 713, 724–25 (N.D. Tex. 2009). In this case, the SEC charged Dallas entrepreneur Mark Cuban with insider trading pursuant to Rule 10b-5 for selling 600,000 shares of the stock of an internet search engine company on the basis of material nonpublic information concerning an impending stock offering. *Id.* at 717–18. Relying on the misappropriation theory of insider trading liability and Rule 10b5-2, the SEC argued that Mr. Cuban had a duty to refrain from trading once he agreed to keep the information about the stock offering confidential. *Id.* at 721. However, U.S. District Court Chief Judge Sidney Fitzwater ruled that an agreement can give rise to misappropriation liability only if it includes both a duty of confidentiality and a commitment to refrain from using the confidential information in a trading transaction. *Id.* at 724. According to the court, "[t]he agreement . . . must consist of more than an express or implied promise merely to keep information confidential. It must also impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain." *Id.* at 725. Because the SEC's complaint alleged only that Mr. Cuban's agreement was one of confidentiality, and not one of confidentiality *and* non-use, the court dismissed it without prejudice. *Id.* at 731.

373. Posting of Annette L. Nazareth to the Harvard Law School Forum on Corporate Governance and Financial Regulation, http://blogs.law.harvard.edu/corpgov/2009/07/20/sec-v-cuban-decision-casts-doubt-on-sec-position-on-insider-trading/ (July 20, 2009, 14:23 EST).

374. Choi, *supra* note 318, at 565–66.

375. *See* DAVIS & ALOGNA, *supra* note 1, at 5.

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 in the context of confidentiality agreements.

VI. 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.[376]

Even before the financial crisis that began in the fall of 2008, shareholders at many U.S. companies advocated for reforms in executive compensation.[377] Of the various reforms discussed, one in particular received significant attention: shareholder advisory votes on executive compensation, which are commonly referred to as "say on pay" votes.[378] Say on pay has received the support of the Council of Institutional Investors,[379] the Interfaith Center for Corporate Responsibility,[380] RiskMetrics Group,[381] and other policy groups.[382] In its most basic form, the practice enables shareholders to democratically express their approval or disapproval of the executive remuneration packages at their firms.[383] Though say on pay votes are nonbinding on the board,[384] they place considerable pressure on companies to reform their compensation policies and can even lay the groundwork for litigation.[385] Moreover, as previously discussed, the pressures to heed shareholder warnings 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.

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376. *See, e.g.*, Eric Dash, *Compensation Experts Offer Ways to Help Curb Executive Salaries*, N.Y. TIMES, Dec. 30, 2006, at C1 (discussing methods for effectively limiting executive pay).

377. *See id.*

378. *See* Labaton & Wohl, *supra* note 262, at 18–20; Gretchen Morgenson, *Verizon Shareholders to Vote on Pay for Top Executives*, N.Y. TIMES, Nov. 2, 2007, at C8; Davis, *supra* note 271, at 3; Johnson & Summerfield, *supra* note 134, at 1.

379. *See* COUNCIL OF INST. INVESTORS, GOVERNANCE POLICIES 9 (2009), *available at* http://www.cii.org/policies (follow "Full Council Corporate Governance Policies" hyperlink).

380. *See* Interfaith Center on Corporate Responsibility, Policy, http://www.iccr.org/issues/policy/index.php (last visited Nov. 14, 2009).

381. *See* RiskMetrics Group, Principles and Board Guidelines, http://www.riskmetrics.com/guidelines (last visited Nov. 14, 2009).

382. *See* Davis, *supra* note 271, at 8.

383. *See id.* at 5.

384. *See id.*

385. Posting of Larry Ribstein to Ideoblog, http://busmovie.typepad.com/ideoblog/2009/02/the-sec-from-fraud-accessory-to-quack-corporate-governance.html (Feb. 19, 2009, 06:06 CST).

Though still relatively new in the United States, say on pay has been a fixture at corporations in the United Kingdom, which became the first country to require shareholder advisory votes on compensation in 2003.[386] Recent empirical work has 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.[387] In addition to discussions about executive pay, large shareholders are now frequently asked to comment privately on board appointments and other routine governance matters.[388] The research 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.[389] 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.[390]

The rise in direct board–shareholder dialogue was an almost overnight phenomenon in the U.K. after GlaxoSmithKline's (GSK) board suffered an unexpected defeat in 2003.[391] 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.[392] The package failed with 50.7% of shareholders voting against it.[393] Though admittedly nonbinding on the board, the result triggered widespread negative publicity against the firm and embarrassment for its directors.[394] Since that time, the firm holds two annual roundtable meetings with approximately a dozen institutional investors in both the U.K. and the U.S. to discuss executive compensation.[395] 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 the public embarrassment that would result from a defeat.[396]

According to the Association of British Insurers, the level of private communication between boards and shareholders in the U.K. tripled after GSK's

386. Davis, *supra* note 271, at 9. After the U.K.'s adoption of say on pay, the countries of Australia and Sweden followed suit. *Id.* at 8.

387. *See id.* at 10–14.

388. *Battling for Corporate America*, *supra* note 184, at 71.

389. *See* Davis, *supra* note 271, at 11.

390. *See id.* at 10.

391. *Id.*

392. *See Glaxo Defeated by Shareholders*, BBC NEWS, May 19, 2003, http://news.bbc.co.uk/2/hi/business/3038381.stm.

393. *Id.*

394. *See id.* ("But the scale of the protest vote proved to be humiliating for the GSK board . . . ."); *see also* Davis, *supra* note 271, at 9 ("The widely-reported vote result, though non-binding, proved both a repudiation of GSK's own complacent attitude toward shareowner communication and an embarrassing hit to the reputations of the firm's directors.").

395. Davis, *supra* note 271, at 23.

396. *See id.*

defeat.[397] Such communication ranges from phone conversations to multiple high-level, in-person meetings between institutional investors and directors.[398] In most cases, the negotiations result in boards changing their compensation plans in ways that more closely link performance with pay.[399]

The increasing levels of communication in the U.K. have also led to fewer confrontations between boards and shareholders.[400] As indicated in Part II, activists in the U.S. frequently feel compelled to submit formal shareholder proposals under Rule 14a-8 before trying direct negotiations with the target board.[401] These proposals, however, may result in the board taking on a defensive posture that actually chills private dialogue.[402] By contrast, funds in the U.K. now consider formal shareholder proposals as a last resort.[403] 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."[404] This has led many institutional investors in the U.K. to devote specific departments and personnel to board–shareholder negotiations.[405]

Negotiations may also help to resolve intraboard 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. 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.[406] The United Kingdom Department of Trade and Industry, for example, stated that say on pay has had the effect of "'enhanc[ing] the competitiveness of the U.K. economy'" through "'better planning by corporations'" and "'better dialogue with investors.'"[407] This sentiment was echoed by authorities at the London Stock Exchange and by four of the world's largest funds, who wrote to

397. *Id.* at 10.

398. *Id.*

399. *See id.*

400. *See id.* at 20 ("In Britain . . . most investors consider the act of submitting a challenge resolution to an annual meeting as a last and hostile resort following a breakdown in relations with the company.").

401. *See supra* note 28 and accompanying text.

402. *See* Posting of Lisa Fairfax to Conglomerate Blog, http://www.theconglomerate.org/2009/04/shareholder-proposals-and-communication.html (Apr. 21, 2009).

403. *See* Davis, *supra* note 271, at 20.

404. *Id.*

405. *Id.* at 23.

406. *Id.* at 14.

407. *Id.*

the SEC in favor of mandatory "say on pay" votes as a way to improve the attraction of U.S. markets to foreign capital.[408]

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.[409] Even before the recent financial crisis, say on pay resolutions were emerging on the annual proxy statements of U.S. companies with growing regularity.[410] Approximately seventy say on pay proposals were submitted to public companies during the 2008 proxy season.[411] These resolutions were supported by an average of 42% of votes, with ten receiving majority support.[412] In the 2009 proxy season, as many as 100 say on pay proposals were submitted to U.S. companies.[413]

Say on pay has received even greater attention now that regulators have started shaping their responses to the recent economic crisis.[414] As part of the American Recovery and Reinvestment Act of 2009,[415] 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.[416] This means that in its annual proxy statement, each institution receiving stimulus funds must provide a separate nonbinding shareholder vote to approve the compensation of the institution's executives as disclosed pursuant to the SEC's compensation disclosure rules.[417] The disclosure must include items such as a compensation discussion and analysis and compensation tables.[418]

These requirements build on public comments made by SEC Chair Mary Schapiro and several SEC Commissioners who have encouraged companies to voluntarily adopt say on pay provisions in light of the financial crisis.[419]

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408. *Id.*

409. *Id.* at 15.

410. *See* Posting of Annette L. Nazareth to the Harvard Law School Forum on Corporate Governance and Financial Regulation, http://blogs.law.harvard.edu/corpgov/2009/02/27/%e2%80%9csay-on-pay%e2%80%9d-now-a-reality-for-tarp-participants/#more-901 (Feb. 27, 2009, 11:42 EST).

411. *Id.*

412. *Id.*

413. *Id.*

414. *See* Orol, *supra* note 12.

415. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (codified as amended in scattered sections of 26 U.S.C., 42 U.S.C., and numerous other titles).

416. *See* Shareholder Approval of Executive Compensation of TARP Recipients, Exchange Act Release No. 60,218, 2009 WL 1884113, at *2 (proposed July 1, 2009); *see also* Orol, *supra* note 12 ("The say-on-pay proposal would allow shareholders a non-binding vote on the pay packages of executives of financial institutions that have accepted funds as part of TARP.").

417. *See* Shareholder Approval of Executive Compensation of TARP Recipients, 2009 WL 1884113, at *10.

418. *Id.*

419. *See* Walter, *supra* note 2; S.E.C. Commissioner Backs 'Say on Pay,' *supra* note 2.

Moreover, as the experience in the U.K. reveals, once shareholders begin voting on pay, their interest in engaging boards on other matters is also likely to awaken.

VII. 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 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 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.

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