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Shareholder Collaboration

Law Working Paper N° 415/2018
Revised July 2020

Jill E. Fisch
University of Pennsylvania and ECGI

Simone M. Sepe
University of Arizona, Université Toulouse 1 Capitole, IAST and ECGI

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We are grateful for comments received at the American Law & Economics Association Annual Meeting, the Law & Economics Seminar at Duke Law School, the Center for Financial Studies in the House of Finance at Goethe University, the lunchtime seminar in law at Université du Luxembourg, the Institutional Investor Activism and Engagement Conference at Bar Ilan and Hebrew Universities, and the SIDE—ISLE 2017—13th Annual Conference at LUMSA University in Rome.

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Abstract

Two models of the firm dominate corporate law. Under the managementpower model, decision-making power rests primarily with corporate insiders (officers and directors). The competing shareholder-power model defends increased shareholder power to limit managerial authority. Both models view insiders and shareholders as engaged in a competitive struggle for corporate power in which corporate law functions to promote operational efficiency while limiting managerial agency costs.

As scholars and judges continue to debate the appropriate balance of power between shareholders and insiders, corporate practice has moved on. Increasingly, the insider–shareholder dynamic is collaborative, not competitive. This Article traces the development of insider–shareholder collaboration, explaining how collaboration, which originated in the venture capital context, has expanded into public companies. This expansion, the Article argues, is due to the increasing importance of partial information problems that, for many firms, have grown costlier than agency costs. Using insights from the economics of information, the Article shows how collaboration promotes the production and aggregation of information from insiders and shareholders, adding value that is lost under unilateral decision-making.

Modern corporate law and corporate governance are poorly prepared to handle insider–shareholder collaboration, however. The collaborative process places novel demands on traditional obligations of confidentiality and fiduciary duty as well as complicating the meaning of conflicts of interest. These concepts must be rethought to enable productive collaboration while limiting the potential that the collaborative process can be manipulated to permit collusive behavior or self-dealing.

Keywords: Corporations, corporate governance, venture capital, hedge fund activism, publicly-held companies, theory of the firm, private ordering, spectrum of shareholder collaboration, collaborative insider-shareholder model, enhancement of shareholder information, management, shareholders

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Jill E. Fisch*
Saul A. Fox Distinguished Professor of Business Law
University of Pennsylvania, School of Law
3501 Sansom Street
Philadelphia, PA 19104, United States
phone: +1 215 746 3454, fax: +1 215 573 2025
e-mail: jfisch@law.upenn.edu

Simone M. Sepe
Professor of Law and Finance
University of Arizona, James E. Rogers College of Law
1201 E. Speedway Blvd
Tucson, Arizona 85721, United States
phone: +1 520 626 3533
e-mail: sms234@email.arizona.edu

*Corresponding Author

University of Pennsylvania Law School

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Jill E. Fisch
UNIVERSITY OF PENNSYLVANIA

Simone M. Sepe
UNIVERSITY OF ARIZONA - JAMES E. ROGERS COLLEGE OF LAW

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Shareholder Collaboration

Jill E. Fisch* and Simone M. Sepe**

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Introduction

Since the groundbreaking work of Ronald Coase in 1937,[1] law and economics scholars have debated theories of the firm and their application to

* Saul A. Fox Distinguished Professor of Business Law, University of Pennsylvania Law School.

** Professor of Law and Finance, James E. Rogers College of Law, University of Arizona and Toulouse School of Economics. We are grateful for comments received at the American Law & Economics Association Annual Meeting, the Law & Economics Seminar at Duke Law School, the Center for Financial Studies in the House of Finance at Goethe University, the lunchtime seminar in law at Université du Luxembourg, the Institutional Investor Activism and Engagement Conference at Bar Ilan and Hebrew Universities, and the SIDE—ISLE 2017—13th Annual Conference at LUMSA University in Rome.

1. *See generally* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

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corporate law. Two models have come to dominate: the management-power model and the shareholder-power model. The management-power model, consistent with Coase's account of the firm as a hierarchical organization,[2] emphasizes the board's decision-making authority.[3] The competing shareholder-power model deemphasizes management authority in favor of accountability and defends greater shareholder power to ensure that corporate insiders—both directors and managers—are held fully accountable.[4]

Proponents of both models agree on two things, however. First, they regard managerial moral hazard as the central problem of corporate law.[5] Second, both assume that insiders and shareholders are engaged in a competitive struggle for corporate power.[6] Under this shared assumption, corporate law entails a narrative of recurring battles with winners and losers.

Meanwhile, the corporate world has moved on. Shareholders are no longer dispersed and passive but empowered, yet they are using their greater power not to wrest control but to work jointly with insiders, bringing new

2. *Id.* at 390–92.

3. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 557–59 (2003) (describing exclusive board authority as essential to overcome the collective action problem affecting corporate production); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 313 (1983) (emphasizing the role of the board as a decision controller charged with monitoring and ratifying management decisions).

4. *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 865–70 (2005) (arguing for giving shareholders the power to initiate changes in the corporate charter and the state of incorporation); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 694–711 (2007) (advocating reforming corporate elections to give more power to shareholders).

5. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248–49 (1999) (arguing that the dominant view in contemporary discussions of corporate governance is that the "central economic problem addressed by corporation law is reducing 'agency costs' by keeping directors and managers faithful to shareholders' interests"); Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1624 (2015) ("[S]hareholders' ability to minimize managerial agency costs is one of the most important challenges in the corporate governance of widely held firms."). Berle and Means first observed that the separation of ownership from control in the public corporation had the potential to generate managerial opportunism and reduce firm value. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 84–89 (William S. Hein & Co., Inc. reprt. ed. 1982) (1932). Jensen and Meckling later formalized the intuition, identifying managerial moral hazard as the primary agency cost arising from the information asymmetry between insiders and shareholders. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

6. *See, e.g.*, Jay B. Kesten, *Towards a Moral Agency Theory of the Shareholder Bylaw Power*, 85 TEMP. L. REV. 485, 486–87 (2013) (describing corporate bylaws "like hostile takeovers, deal protection devices, and proxy access fights before them—the new leading edge of a decades-long struggle between shareholders and management over the allocation of decision-making authority in public companies"); Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1328–29 (2013) (discussing the long-term battle between shareholders and managers and suggesting that in recent years shareholders seem to have gained the upper hand in this battle).

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information and insights to operational decision-making.[7] In other words, increasingly, the insider–shareholder dynamic in the modern corporation is *collaborative*.

Insider–shareholder collaboration is occurring in multiple ways—through private engagement between large shareholders and corporate executives and directors, through joint initiatives aimed at developing and promoting the spread of shared governance principles, through "constructivist" activist interventions oriented to the creation of long-term value, and through the increasing use of hybrid boards of directors to formalize shareholder inputs over operational decision-making. Although we do not claim that collaboration has displaced hostile activism, we document how the trend toward board–shareholder collaboration is spreading rapidly and systemically.[8]

What explains the growth of collaboration? Using insights from epistemic models of collective wisdom and the economics of information, this Article demonstrates that collaboration promotes the production and aggregation of the "partial" and "complementary" information that insiders and shareholders are likely to possess in today's knowledge-rich economy. Because of this distinctive property, collaboration offers a mechanism for enhancing firm value that unilateral decision-making by either insiders or shareholders cannot provide.

The Article also explains how this mechanism can be traced back to the venture capital (VC) context, in which founders and investors have long-developed structures that promote shared power and joint decision-making—collaborating with rather than competing against each other. Indeed, in the VC context, which emphasizes innovation and rapid growth, the traditional corporate law concern of minimizing agency costs is secondary to what we call "partial information" problems.[9] These problems arise when the nature

7. We distinguish collaboration from communication in that it involves shareholders and insiders working together rather than simply exchanging information. *See* Rosabeth Moss Kanter, *Collaborative Advantage: The Art of Alliances*, HARV. BUS. REV., July–Aug. 1994, at 96, 97 (defining collaboration as "creating new value together"); *see also* Debra Mashek, *Collaboration: It's Not What You Think*, PSYCHOL. TODAY (Feb. 22, 2016), https://www.psychologytoday.com/intl/blog/relationships-intimate-and-more/201602/collaboration-its-not-what-you-think?amp [https://perma.cc/6HJF-AVAJ] (distinguishing collaboration from networking, coordinating, and cooperating).

8. One article suggests that the relationship between activists and targeted companies is moving toward a "new, collaborative (or at least less adversarial) conception," but the analysis is largely limited to the hedge fund context and to the implication for golden leash practices. Gregory H. Shill, *The Golden Leash and the Fiduciary Duty of Loyalty*, 64 UCLA L. REV. 1246, 1256–59, 1261–64 (2017). In contrast, this Article examines the potential for a broader-scope collaborative model of the insider–shareholder relationship.

9. Asymmetric information no longer is only "unilateral," with outsiders necessarily standing at an informational disadvantage relative to insiders, but is increasingly "bilateral," with both insiders and outsiders holding private information not available to the other party. *See* Frederik

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of the production process is so knowledge intensive that a single individual or groups of individuals—including the firm's founders, officers, and directors—is unlikely to possess the relevant information to respond effectively to *all* business challenges. Instead, *both* insiders *and* outsiders—such as VC funds—likely possess information that is not available to the other party but is vital to the firm's success. VC firms access these different sets of information through collaborative decision-making structures.

Two factors explain the spread of collaboration to the publicly traded firm. First, the information dependency of the public firm business model has increased as new technology firms enter the public markets and older firms modernize their business plans. Second, the rise of empowered and actively informed investors offers a new source of well-resourced and sophisticated firm-specific knowledge from *outside* the corporation. Growing market concentration has led to the emergence of institutional investors with large stakes and both the incentive and sophistication to acquire valuable information.[10] These investors have increasingly come to resemble VC investors in that they are likely to possess information that is not just different but also "complementary" to that of insiders. This means that the informational whole of insider and outsider information is arguably greater than the sum of its individual parts so that the aggregation of this information adds to firm value. It follows that public firms have begun to incorporate both the inside information of insiders and the outside knowledge of investors—similar to what happens in the VC context.

Despite these dramatic transformations, corporate law scholars have paid virtually no attention to insider–shareholder collaboration. This Article attempts to remedy the gap. As a descriptive matter, it offers the first taxonomy of the various forms of collaboration that we increasingly observe in corporate practice. It then draws on the theory of cooperative games to demonstrate how the corporate structure provides appropriate incentives for the generation and aggregation of partial and complementary information.

First, the equity contract efficiently addresses collaboration's economic rights by ensuring that the surplus created by collaboration is shared by both collaborating and noncollaborating investors, as well as equity-compensated managers. Second, the corporate structure efficiently allows parties to design control rights so as to reflect a party's marginal contribution to the surplus created by collaboration, preserving the incentives to invest optimally in the production of complementary information and the collaborative process more generally.

Andersson, *Adverse Selection and Bilateral Asymmetric Information*, 74 J. ECON. 173, 174–75 (2001) (examining bilateral asymmetric information in the insurance context). For clarity, this Article uses the term "partial information" in the place of "bilateral asymmetric information."

10. *See, e.g.*, Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 313 (2017) (documenting the growth and increasing ownership concentration of large-asset managers).

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Corporate law rules are poorly prepared to handle insider–shareholder collaboration, however. These rules typically limit shareholders to communicating information to insiders rather than collaborating.[11] Although board representation offers public company shareholders a vehicle to collaborate, shareholder representatives face questions about the scope of their fiduciary duties and the potential for conflicts of interest. Effective collaboration may also result in greater shareholder access to firm-specific information, but with that access comes concerns over the misuse of that information, either to obtain a trading advantage or for other forms of self-dealing. Finally, collaboration creates the possibility of collusion in which collaborating investors and insiders act opportunistically to further their own interests at the expense of overall firm value. Although a complete analysis of these concerns is beyond the scope of this Article, we argue that the way in which they are treated under current corporate law rules should be rethought if the goal is enabling productive collaboration while limiting the potential for abuse.

The Article proceeds as follows. Part I summarizes the traditional confrontational model of corporate law. Part II describes the shift from confrontation to collaboration and explains how collaboration has migrated from the VC context to the publicly traded company, providing a first taxonomy of the several forms of insider–shareholder collaboration. Part III defends the normative desirability of the collaborative model, explaining how collaboration responds to a growing partial information problem and using insights from game theory to demonstrate how the corporate form can preserve the individual incentives of insiders and shareholders to collaborate. Part IV identifies how the collaborative model presents new challenges for corporate law.

I. Confrontational Theories of the Firms

Traditional "confrontational" models of the corporation assume that the essential task of corporate law is devising the appropriate allocation of power between insiders and shareholders to minimize the cost of managerial moral hazard. Although commentators differ in their views as to the appropriate allocation of such power—with some supporting managerial primacy and others favoring empowered shareholders—the dominant narrative in either case is that insiders and shareholders are engaged in a competitive struggle for corporate power.

11. *See infra* section IV(A)(1).

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A. The Management-Power Model

The traditional management-power model, reflected in the writings of Martin Lipton,[12] Stephen Bainbridge,[13] and the Delaware courts,[14] relies on the board of directors to centralize corporate decision-making authority and to address the problem of managerial moral hazard. The model "free[s] up managers to manage."[15] Shareholders, in this model, specialize in risk-bearing but are not involved in operational issues.[16] The key arguments for granting ultimate authority to the board include not only shareholder collective action problems and asymmetric information but also concerns about shareholder short-termism, self-dealing, and conflicts of interest.[17]

This account of the corporation finds its roots in the managerialist era that began at the end of World War II and ended around 1980.[18] The managers that oversaw the growth of the modern industrial corporation were brought in to "hire capital from the investor"[19] and enjoyed a nonreviewable power of fiat.[20] Shareholders, on the other hand, were dispersed and passive, with few mechanisms to overcome collective action problems, and hence dismissed as mere capital providers.[21] Even back then, as attested by Berle's and Means's classic treatise,[22] management power was seen as problematic,

12. *See, e.g.*, Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 757–58 (2007) (defining the "the director-centric Delaware way"); Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 130–31 (1979) (defending board power in the takeover context).

13. *See, e.g.*, Bainbridge, *supra* note 3, at 560, 569 (describing the board's exclusive authority as its undisturbed "power of fiat").

14. *See, e.g.*, Jack B. Jacobs, *"Patient Capital": Can Delaware Corporate Law Help Revive It?*, 68 WASH. & LEE L. REV. 1645, 1657–61 (2011) (attributing national economic decline to, among other causes, the erosion of board power); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1763 (2006) (explaining that the traditionalist Delaware way is "the empowerment of centralized management to make and pursue risky business decisions through diverse means").

15. Strine, *supra* note 14, at 1764.

16. Fama & Jensen, *supra* note 3, at 309.

17. *See* Lipton & Savitt, *supra* note 12, at 744–47 (explaining dangers of conflicts of interest from interest-group shareholders and short-termism caused by vocal, institutional shareholders); Strine, *supra* note 14, at 1764 (describing traditional managerialist's concern for selfish interests of institutional investors).

18. *See, e.g.*, ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 482–83 (1977) (describing the managerial revolution); GERALD F. DAVIS, MANAGED BY THE MARKETS 72–77 (2009) (describing managerial dominance during this period).

19. Bayless Manning, Book Review, 67 YALE L.J. 1477, 1489 (1958).

20. *See* ADOLF A. BERLE, THE AMERICAN ECONOMIC REPUBLIC 169–70 (1963) (noting that before 1920 "owner-managers considered their prerogatives absolute").

21. Adolf A. Berle, *Property, Production and Revolution: A Preface to the Revised Edition* of ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, at vii, xxvi–vii (Harcourt, Brace & World, Inc. rev. ed. 1968) (1932).

22. BERLE & MEANS, *supra* note 21, at 207.

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but under the Coasian assumption that the market could not provide an environment conducive to complex production,[23] it was deemed unavoidable.

Since the early 1980s, however, a variety of developments have limited the scope of management power. The hostile takeover offered, for the first time, a vehicle through which capital market discipline could be used to constrain managerial agency costs by demonstrating the transformative potential of shareholders' stock market purchasing power.[24] And after the demise of takeovers, the rise of institutional investors and governance watchdogs intervened to provide a novel form of market discipline.[25] The introduction of incentive compensation also increased the alignment between managers' interests and maximization of firm value.[26] And the emergence of independent directors led to greater monitoring of managers.[27]

For management-power supporters, these developments heighten arguments to defend the model by providing incentives for managers to focus on the maximization of firm value and hold them accountable for doing so. These scholars also see these developments as strengthening the case for protecting management and the board from the potential interference of less-informed investors.[28] Not so for the defendants of the competing shareholder-power model, as we shall see next.

B. The Shareholder-Power Model

The rise of the shareholder-power model can be traced back to the emergence of hostile takeovers. Indeed, takeovers led to a new way of thinking about the corporation, one largely shaped by the rise of the neoclassical theory of the firm. Rejecting centralized decision-making as a

23. *See* Coase, *supra* note 1, at 392 (explaining that use of the firm can reduce the transaction costs associated with market transactions).

24. *See* William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1520–21 (1989) (describing the takeovers that arose in the 1980s as "capital markets' successful demand for the return of capital suboptimally invested").

25. David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587, 592–93 (2005).

26. *See, e.g.*, Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 884, 896–97 (2002) (describing both the rise of incentive compensation and independent directors as adaptive responses to the managerial-friendly takeover standards set by Delaware courts).

27. *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1518 (2007) (defending the increased use of independent directors as a value-increasing innovation of the post-takeover era); *see also* Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 270–71 (1997) (describing the rise of the monitoring board).

28. *See, e.g.*, Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 455 (2014) (describing the view of some commentators that "the best way to ensure that corporations generate wealth for diversified stockholders is to give the managers of corporations a strong hand to take risks and implement business strategies without constant disruption by shifting stock market sentiment").

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distinctive trait of totalitarianism,[29] neoclassicists viewed the firm as a web of contractual relationships among individuals, whose ongoing transactions were efficiently coordinated by the price mechanism.[30] The introduction by Jensen and Meckling of the principal–agent model of the firm formalized and directed the change of approach.[31] Easterbrook's and Fischel's contractarianism refined the model for corporate law, using it to support a sequence of normative assertions that revolved around a view of shareholders as the primary corporate constituents.[32]

The shareholders' claim to primacy was put to test in the wake of the fall of the hostile takeover and the introduction of legal and governance responses empowering incumbent managers to adopt antitakeover measures.[33] These reforms prompted commentators fiercely to debate whether management's use of antitakeover measures was appropriate or whether management should instead remain passive and allow shareholders the freedom to decide whether to accept a hostile bid.[34] The scene was set for the battle between shareholders and managers over corporate control.

That battle intensified in the early 2000s, when the case for shareholder primacy expanded beyond the control contest. Lucian Bebchuk was perhaps the most vocal commentator to argue that shareholders should be given greater power, including powers that were currently reserved to corporate insiders.[35] In recent years, steady increases in shareholder concentration and activism have led to greater shareholder control over corporate decision-making and increased issuer responsiveness to shareholder demands. As put by one commentator, for the first time since the beginning of the battle

29. *See* DAVID CIEPLEY, LIBERALISM IN THE SHADOW OF TOTALITARIANISM 87–88 (2006) (describing the role of totalitarianism in mid-twentieth-century American views on economic reform).

30. Armen A. Alchian, *Production, Information Costs and Economic Organization*, *in* ECONOMIC FORCES AT WORK 73, 73–74 (1977).

31. *See generally* Jensen & Meckling, *supra* note 5.

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

33. *See, e.g.*, Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 864–65 (1993) (describing the legal and political barriers as resulting in the "demise of the market for corporate control"); *see also* Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, J. ECON. PERSP., Spring 2001, at 121, 132 (examining the changed landscape for takeovers and mergers and suggesting "anti-takeover legislation has had an effect").

34. *Compare* Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 821–22 (1982) (criticizing the use of antitakeover defenses), *with* Lipton, *supra* note 12, at 130–31 (defending the use of antitakeover defenses to protect board primacy).

35. *See supra* note 4.

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between shareholders and insiders over corporate power, the battle has come to favor shareholders rather than directors and managers.[36]

C. The "Battle" Between Insiders and Shareholders

Both the management-power model and the shareholder-power model assume that insiders and shareholders are engaged in a competitive struggle for corporate power. The language of combat goes back to the "takeover battles" of the 1970s, which featured "corporate raiders," "white knights," "scorched earth takeover defenses," "poison pills," and "greenmail."[37] Although the conflicts between shareholders and insiders today rarely involve hostile contests for corporate control, the struggle for corporate power has, if possible, intensified. Hostile activists have taken the place of corporate raiders, and the ongoing engagement between activists and issuers continues to be described as a "war."[38]

The language of combat persists. A white paper directed at corporate boards, for example, termed majority voting "the next battleground in the corporate governance wars between the activist institutional shareholder community and 'Corporate America.'"[39] Similarly, Fortune magazine described Trian's recent activist campaign at DuPont as "war."[40] A letter sent to American CEOs by Blackrock's Larry Fink in 2014 expressed concerns that activists are out to "destroy jobs."[41] And Delaware Supreme Court Chief Justice Leo Strine's recent essay describes activist "wolf packs" and asked, "Who Bleeds When the Wolves Bite?"[42]

The confrontational approach is likewise reflected in the characterization of the objectives of each model. Adherents to the management-power model defend it in terms of the need to protect the

36. Klausner, *supra* note 6, at 1329 ("In recent years, however, the balance of power seems to have shifted toward shareholders. After a thirty-year delay, and key changes in the background law, governance structures that shareholders advocate have been adopted.").

37. *See, e.g.*, Gilson, *supra* note 34, at 775–76 (describing target management tactics as "drawing directly on military jargon").

38. Michael D. Goldhaber, *Marty Lipton's War on Hedge Fund Activists*, AM. LAW. (Mar. 30, 2015), https://www.law.com/americanlawyer/almID/1202721058301/ [https://perma.cc/77PU-HZ3T].

39. *Majority Voting for Directors: The Latest Corporate Governance Initiative*, LATHAM & WATKINS: M&A DEAL COMMENT. (Dec. 9, 2005), https://www.lw.com/upload/pubContent/_pdf/pub1437_1.pdf [https://perma.cc/HU4X-GVQA].

40. Stephen Gandel, *DuPont Nearly Lost Its War with Activist Nelson Peltz*, FORTUNE (June 4, 2015), http://fortune.com/2015/06/04/dupont-nelson-peltz-vote/ [https://perma.cc/QE2K-2B9K].

41. William Alden, *Laurence Fink Says Activist Investing Can 'Destroy Jobs*,*'* N.Y. TIMES: DEALBOOK (Dec. 11, 2014), https://dealbook.nytimes.com/2014/12/11/laurence-fink-says-activist-investing-can-destroy-jobs/ [https://perma.cc/9VJM-NSA4] (quoting comments by Mr. Fink at a DealBook conference).

42. Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1875 (2017).

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corporation from the short-term interests of activist shareholders.[43] And shareholder advocates persevere in their call to increase shareholder power to reduce managerial agency costs.[44] In other words, both sides view the preservation of power as necessary to curb the tendencies of the opposition to destroy or appropriate firm value.

It is a mistake to conclude, however, that a confrontational model is an inherent feature of corporate law. Black letter corporate law—whether statutory or case law—merely provides a starting point for managing the insider–shareholder relationship. Corporations respond to economic and legal developments through private ordering,[45] adopting contractually based adjustments to statutory default terms and changing external circumstances. This adjustment process has accommodated collaborative, in addition to confrontational, interactions between shareholders and corporate insiders, most notably in the venture capital context. Most importantly, as we will show below, the changes that have occurred in corporate production and the role of shareholders have prompted the adoption of similar collaborative structures in an increasing number of public corporations in recent years, denuding confrontational models of their descriptive value.

II. From Confrontation to Collaboration

A. Venture Capital and the Emergence of Collaboration

Consistent with adversarial theories of the corporation, confrontational corporate governance arrangements provide for unilateral power, by either the board or the shareholders. In the managerialist era, for example, corporations reflected unilateral managerial power. At the opposite extreme, we find the hostile-activist context, in which hedge funds, as empowered shareholders, can often shape a firm's business policy unilaterally. A confrontational allocation of corporate power is not the sole possibility, however. Corporate law structures insider and shareholder inputs, but it does not dictate the details of this process; those details are left to private ordering. And under private ordering, collaboration is an alternative to confrontation.

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43. *See, e.g.*, Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1093–96 (2015) (providing an overview of the scholarly positions defending what they refer to as the "myopic-activists claim").

44. *See* Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1643–44 (2013) (rejecting the claim that shareholder activism promotes short-termism).

45. Private ordering occupies the space of contractual freedom that is available under default rules and encompasses both contracting within the corporation and discrete market contracting. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426 (1989) (describing the corporation as "a set of implicit and explicit contracts").

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VC firms offer the paradigmatic example of the collaborative alternative.[46] VC founders and investors routinely bargain for structures that provide for shared power and joint decision-making rather than unilateral decision-making authority by either insiders or investors.[47] We argue that these collaborative structures respond to a distinctive feature of VC firms: the fact that they are typically invested in innovation and high growth.[48] As Ron Gilson has explained, various features of VC-funded start-up firms make them particularly conducive to innovation.[49] And innovative businesses are heavily dependent on information—both information about the firm's business model, invention, or technology, and information about the relationship of the firm's innovation to the existing industry. In such cases, both entrepreneurs and investors suffer from "partial information" problems; each is likely to possess valuable private information for matching firm-specific innovation to the surrounding business environment, but only when that information is combined can it be fully exploited to foster a firm's success.

VC firms address this problem through collaborative decision-making structures that create incentives for all participants to develop and aggregate their partial information. Staged financing, the explicit provisions of joint control rights, and the appointment of constituency directors all offer examples of these collaborative structures.

Staged financing provides for the incremental investment of capital over time, typically conditional on how a start-up progresses in relation to its

46. Additional, although less salient, evidence of collaborative practices comes from incentive-based management compensation and independent directors. *See* Gordon, *supra* note 27, at 1471 (observing that independent directors can not only channel shareholder inputs but can also credibly check these inputs against insider measures of firm prospects); Kahan & Rock, *supra* note 26, at 884, 896–97 (describing increased use of incentive compensation in response to takeover barriers).

47. *See, e.g.*, William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 920 (2002) (describing "shared control structure's real world dominance over the alternative of *VC* control or hardwired control transfers"); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1081 (2003) ("The venture capital fund-portfolio company contract stands the Berle-Means problem on its head."); D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 139 (1998) (describing the relationship between VC investors and entrepreneurs as a "cooperative relationship").

48. *See, e.g.*, Gilson, *supra* note 47, at 1068 ("The venture capital market thus provides a unique link between finance and innovation, providing start-up and early stage firms—organizational forms particularly well-suited to innovation—with capital market access that is tailored to the special task of financing these high-risk, high-return activities.").

49. *See* Ronald J. Gilson, *Locating Innovation: The Endogeneity of Technology, Organizational Structure, and Financial Contracting*, 110 COLUM. L. REV. 885, 900–04 (2010) (arguing that VC-funded firms are well suited for dealing with high levels of risk); *see also* Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383, 392 (2017) (observing that the success of many innovative firms involves regulatory entrepreneurship, which they define as pursuing a line of business that depends on changing the applicable law).

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initial projection.[50] Two collaborative features are inherent in this mechanism. First, staged financing necessarily presupposes an ongoing relationship between the investors and the entrepreneur that involves regular rather than sporadic communications as well as periodic consultation.[51] Indeed, only through frequent interactive exchanges with the entrepreneur can VC investors acquire the information needed to employ staged financing successfully as a means to minimize their investment risk.[52] Second, staged financing implicitly provides for shared decision-making power between the investors and the entrepreneur. It does so by ensuring that decision-making power rests with the entrepreneur until it becomes optimal for this power to shift to the investors, enabling them to reclaim further authority through their control of subsequent funding.[53]

VC contracts also typically provide for joint decision-making rights rather than vesting operational decision-making exclusively in the hands of either insiders or investors. For example, VC contracts frequently allocate control and monitoring rights to VC investors that are disproportionate to their equity share.[54] VC investors also usually enjoy veto powers over fundamental corporate decisions so that crucial actions in the development of a start-up business require the consensus of *both* the entrepreneur *and* the investors.[55]

Further, VC contracts routinely feature the appointment of constituency directors.[56] Constituency directors are directors whose election to the board

50. Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 52–53 (2006); Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1169–70 (2013).

51. In the jargon of economists, staged financing presupposes a relational contract; that is, an agreement characterized by continuing interactive exchanges between the contracting parties. *See generally* Jonathan Levin, *Relational Incentive Contracts*, 93 AM. ECON. REV. 835 (2003) (discussing the structure of relational contracts).

52. *See, e.g.*, Bartlett, *supra* note 50, at 52 (explaining that staged financing allows VC investors to minimize the risk of investing in unfamiliar businesses by allowing them to observe progress); Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 65 (positing that staged financing reduces the risk to investments by an entrepreneur's threat to quit the venture and from informational hazards).

53. D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 323 (2005). Typically, control stays in the hands of the entrepreneur when the firm is in a "good" state of nature and transfers to the VC investor in a "bad" state of nature. *Id.* at 322. Importantly, as compared to the unilateral allocation of control power to either the entrepreneur or the investor, this allocation of power prevents the entrepreneur from seeking to continue a business when exit is optimal, while also avoiding an investor moving too quickly to abandon a business. *Id.* at 318.

54. Bartlett, *supra* note 50, at 53–54 ("A VC investor . . . [will] negotiat[e] control and monitoring rights that are disproportionate to its stock ownership.").

55. *Id.* at 54 ("[A] VC investor will commonly have veto rights over the issuance of securities, asset sales, mergers, or other important corporate transactions.").

56. *See* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 988–89 (2006) (focusing on the appointment of directors by venture capitalists); Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real*

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is traceable to an identified corporate constituency. In the VC context, constituency directors typically represent the VC investors.[57] Although the fiduciary duty implications of constituency directors are debated in the literature,[58] their appointment is designed to facilitate joint decision-making by allowing investors to engage in a deliberative process with the entrepreneur.[59]

While scholars have attempted to shoehorn these arrangements into the traditional confrontational paradigm, many features of VC contracting are inconsistent with the traditional agency-cost model.[60] As observed by Gordon Smith, the relationship between the VC investors and the entrepreneur involves "a more complex interaction characterized by give-and-take on both sides."[61] In a pure agency relationship, the principal's only obligation is providing pecuniary compensation for the agent's services. Venture capitalists tend to provide more than that. They provide a whole series of "value-added services," such as "identifying and evaluating business opportunities, including management, entry, or growth strategies; negotiating and closing the investment; tracking and coaching the company; providing technical and management assistance; and attracting additional capital, directors, management, suppliers, and other key stakeholders and resources."[62] Because of these added services, the success of a start-up is as likely to depend on the business expertise of sophisticated VC investors as on the entrepreneur's human capital.

VC contracting recognizes the value of the contributions by both the entrepreneur-insider and the VC investors by adopting a model of shared decision-making. A collaborative governance model is better situated than a confrontational one to promote conditions that facilitate the development and aggregation of the valuable firm-specific information of both the entrepreneur and the investors. As we shall see next, the changes that have occurred in corporate production and the role of shareholders have increasingly blurred the line between the VC context and the public-

World: An Empirical Analysis of Venture Capital Contracts, 70 REV. ECON. STUD. 281, 308–10 (2003) (empirically analyzing board composition in VC contracts); *see also* Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461, 462 (discussing the use of third-party independent directors in start-up firms).

57. Fried & Ganor, *supra* note 56, at 988 (observing that the link between a constituency director and the VC investors may be more or less explicit).

58. *See* Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 WASH. U. L. REV. 309, 342–50 (2013) (discussing the relevant case law).

59. *See id.* at 335–37, 340–41 (arguing that constituency directors offer a way to complete the necessary incomplete contracts of venture capitalists and other investors).

60. *See* Bartlett, *supra* note 50, at 57–58 (identifying features of VC contracting that cannot be explained in terms of agency costs).

61. Smith, *supra* note 47, at 139.

62. *Id.* at 134 (quoting WILLIAM D. BYGRAVE & JEFFRY A. TIMMONS, VENTURE CAPITAL AT THE CROSSROADS 13 (1992)).

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corporation context, with the result that many public corporations are also moving from a confrontational model to a collaborative one.

B. The Extension of Collaboration to the Public Corporation

Insider–shareholder collaboration has spread from the VC context to publicly traded firms. Three factors explain this development. First, public firms have become more dependent on the information-intensive environment that has traditionally been the province of start-ups. Second, the shareholder base of public companies is now dominated by large institutional shareholders who are devoting growing sophistication and resources to understanding and engaging with their portfolio companies. As a result, these investors offer firms new sources of information. Third, the modern public-company board consists, almost entirely, of independent directors, creating an information challenge for unilateral board decision-making.

1. Partial Information Problem and the Public Corporation.— Corporate production has undergone a vast transformation in the last thirty to forty years.[63] In the industrial age, corporations derived most of their value from physical assets and manufacturing activities. In the twenty-first-century corporation, instead, firm value increasingly depends on intangible assets, such as technological know-how, patents, research-and-development projects, brand names, and trade secrets.[64] Along the same lines, human capital has also become a specialized resource.[65] Successful corporations today are defined by their ability to access, transfer, and assemble specific knowledge. While one may think of the shift to intangible "knowledge" assets as a process that only affects new economy companies, such as Google, Facebook, Apple, and Tesla, in reality, information increasingly is the key

63. *See* Carol A. Corrado & Charles R. Hulten, *How Do You Measure a "Technological Revolution"?*, 100 AM. ECON. REV. (PAPERS & PROC.) 99, 100 (2010) ("[T]he recent technological revolution, in its various manifestations, is associated with a dramatic shift in the composition of investment spending and in the factors driving the growth of output per worker hour." (emphasis omitted)).

64. As explained by Carol Corrado and Charles Hulten:

> [T]he innovation that has shaped recent economic growth is not an autonomous event that falls like manna from heaven. Nor is it a result of R&D and ICT investments alone. Instead, a surge of new ideas (technological or otherwise) is linked to output growth through a complex process of investments in technological expertise, product design, market development, and organizational capability. This process affects all sources of growth to one extent or another but is most clearly detected in the growing contribution of intangible capital.

Id. at 103.

65. *See, e.g.*, Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, 101 J. FIN. ECON. 621, 622, 627–29 (2011) ("I find a strong, robust, positive correlation between [employee] satisfaction and shareholder returns. This result provides empirical support for recent theories of the firm focused on employees as the key assets . . . ." (citations omitted)); Luigi Zingales, *In Search of New Foundations*, 55 J. FIN. 1623, 1641–42 (2000) (emphasizing the importance of human capital over physical capital in today's corporations).

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driver to success across industries.[66] Moreover, generating and exploiting knowledge demands that knowledge be continually replenished.

As a result, the informational structure of the public corporation has become more complex than reflected in the traditional models of the corporation. Under those models, information issues only mattered in connection to moral hazard and other agency costs, in the form of an asymmetric information problem between insiders and investors. The normative task was then to determine the appropriate balance of shareholder and insider power to limit managerial moral hazard without sacrificing efficient operational decision-making. A presumption about the confrontational nature of the insider–shareholder relationship logically followed.

In today's knowledge-rich economy, however, asymmetric information issues only partially capture the relevance of information for the theory of the firm. Indeed, in this economy, "partial information" problems are likely to matter as much as, if not more than, asymmetric information problems for firm value. As economist Harold Demsetz observed, although information has obvious connections to moral hazard and agency costs, information costs play a bigger role in the theory of the firm.[67] Changes in corporate production and the role of shareholders have increased this role. Successful corporations are defined today by the ability to bring together the vast quantities of information necessary for the production of "'knowledge' assets"[68]—ideas linked to "investments in technological expertise, product design, market development, and organizational capability."[69] In this environment, Demsetz's remark that "[e]conomic organization, including the firm, must reflect the fact that knowledge is costly to produce, maintain, and use"[70] has never been more to the point.

66. *See* Colin Mayer, *Reinventing the Corporation*, 4 J. BRIT. ACAD. 53, 54 (2016) (stating that 80% of the market value of U.S. corporations is nowadays represented by intangible assets).

67. Harold Demsetz, *The Theory of the Firm Revisited*, 4 J.L. ECON. & ORG. 141, 141 (1988). Studies on the issue of the production, aggregation, and dissemination of information within organizations date back to the pioneering work of Simon, Polanyi, and von Mises. *See* MICHAEL POLANYI, PERSONAL KNOWLEDGE 69–71 (Harper Torchbook ed., Harper & Row 1964) (1958) (discussing the concept of tacit or personal knowledge—things that we may know but find impossible to completely and effectively communicate to others); HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR 72–73 (3d ed. 1976) (focusing on the issue of the difficulties and costs associated with transferring information within firms and in markets); LUDWIG VON MISES, HUMAN ACTION 648–50 (1949) (discussing the period of time between changes in market data and the point where the market is adjusted); *see also* Utset, *supra* note 52, at 73–76 (providing an overview of the relevant literature). Over time, however, the study of informational issues in corporate governance has lost its initial general relevance and become limited to matters connected with agency costs.

68. BIG INNOVATION CTR., THE PURPOSEFUL COMPANY: INTERIM REPORT 5 (2016), http://www.biginnovationcentre-purposeful-company.com/wp-content/uploads/2017/11/thepurposefulcompany_interimreport.pdf [https://perma.cc/QK3D-LBNG].

69. Corrado & Hulten, *supra* note 63, at 103.

70. Demsetz, *supra* note 67, at 157.

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Partial information problems have now transferred to the public corporation because the modern corporation's operational complexity makes it highly unlikely that any single individual or organization will possess the relevant information "to respond effectively to *all* business challenges."[71] Rather, information tends to be scattered through a multitude of agents, requiring corporate actors to leverage and pull knowledge from multiple sources. Adding to this informational complexity, the rise of sophisticated and actively informed investors suggests that these investors are increasingly likely to have the capacity to gather relevant knowledge—knowledge that board members may not necessarily share.

Under these different informational assumptions, the normative necessity of a confrontational corporate paradigm disappears. The task is no longer only to determine the appropriate balance of shareholder and manager power to limit managerial moral hazard but also to determine the best way to aggregate the partial information of corporate insiders and shareholders. The increased use of collaborative schemes that we observe in public corporations suggests that these schemes can pursue this task better than traditional competitive schemes.

2. Empowered and Informed Investors.—Capital market developments make it increasingly rational to look to public-company shareholders as sources of valuable information. Modern shareholders no longer fit Berle and Means's account.[72] They have instead become empowered, largely because of the reconcentration of equity ownership,[73] which has increased since the 1990s.[74] Institutional investors now own over two-thirds of the outstanding shares of the thousand largest U.S. public companies.[75] These investors vary in their characteristics—ranging from passive mutual funds that select stocks according to a broad market index to hedge funds whose business model is predicated on identifying companies that they believe underperform industry peers and forcing changes from the inside that can improve corporate performance. In spite of these differences, however, institutional investors of all types have grown increasingly informed as well as increasingly engaged in their portfolio companies.

Similar to VC investors, today's institutional investors bring their knowledge of the market rather than just capital to firms. Hedge funds specialize in developing firm-specific information that they then deploy by

71. BIG INNOVATION CTR., *supra* note 68, at 6 (emphasis added).

72. Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 867 (2013).

73. Other crucial changes occurred in the marketplace including the emergence of proxy advisory firms, the adoption of universal majority voting, and accompanying withhold campaigns. Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEXAS L. REV. 987, 995, 1010–11 (2010).

74. *Id.* at 996.

75. Gilson & Gordon, *supra* note 72, at 865.

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providing governance and strategic inputs to the firms they target.[76] In selecting targets and devising future investment strategies, the funds employ teams of dedicated analysts who pore over financial documents, engage with both the company's existing investors and competitors, and often visit potential targets to gather as much information as possible.[77] Hedge funds also tend to specialize in certain industries or sectors of an industry, around which they build a strong expertise and develop network contacts.[78]

Large institutional investors such as mutual funds are also increasingly engaged in information production and no longer just as "reticent" supporters of initiatives undertaken by activist hedge funds.[79] Asset managers like BlackRock, Vanguard, and State Street—whose combined holdings make them the largest shareholder in 40% of all U.S. listed companies[80]—have both the resources and the incentives to develop governance sophistication and expertise.[81] Many large institutional investors also have in-house teams that are dedicated to gathering governance information and investment insights and formulating policies ranging from board composition to risk management.[82]

Collectively, these developments stand in sharp contrast to the traditional management-power claim that because shareholders are poorly informed they should play a limited role in corporate decision-making. At the same time, the developing skills and inputs of today's shareholders extend far beyond the shareholder-power claim for increased monitoring. Shareholders also provide crucial *informational* inputs, inputs that, as we shall see next, the modern independent board may be unable to provide.

3. Independent Directors and Information Access.—The final development that explains the extension of collaboration to the modern public company is the rise of the independent board. The percentage of independent directors on corporate boards has steadily increased since the

76. *Id.* at 897.

77. OWEN WALKER, BARBARIANS IN THE BOARDROOM 31 (2016).

78. *See id.* at 11–21 (discussing the different business models of major hedge fund players).

79. *See* Gilson & Gordon, *supra* note 72, at 867 (describing institutional investors as "rationally reticent").

80. If we restrict the field to the largest 500 American corporations, share ownership by the "Big Three" (i.e., BlackRock, Vanguard, and State Street) amounts to an astonishing 88%. Fichtner et al., *supra* note 10, at 313. The rise of the Big Three is explained by the massive shift from active toward passive investment strategies, which began after the financial crisis. *Id.* at 302–03. Unlike active funds, passive "index" funds replicate existing stock indices by buying shares of the member firms of a particular index. BlackRock, Vanguard, and State Street largely dominate the passive index fund industry, collectively managing over 90% of all assets under management in passive equity funds. *Id.* at 299, 304.

81. Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 49 (2019).

82. *See id.* at 25 (describing increased engagement of the Big Three with portfolio companies).

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aftermath of the takeover era[83] as a result of various mechanisms that have transformed the independent or "monitoring" board into a virtually mandatory element of the law.[84] Most U.S. boards now consist largely of outsiders with full-time jobs elsewhere who can devote only limited time to the running of the business for which they act as directors.[85] The outpouring of new regulation resulting from the financial crises of the last decade also claims a significant portion of that time, limiting the time that independent directors can spend on information gathering and business decision-making.[86]

In addition, the standards for independence have become increasingly stringent, so much so that, according to some commentators, they "rule[] out just about anybody who has firsthand knowledge of the company and its industry."[87] The emphasis placed on independence requirements can indeed have the effect of sacrificing expertise by disqualifying directors based on their firm or industry ties.[88] The result is that many independent directors lack the firm-specific human capital, knowledge, and skills of executive directors and tend instead to be "generalists."[89] In the best-case scenario, independent directors develop firm-specific expertise over a lengthy process.[90] In the worst-case scenario, they never "develop . . . more than a rudimentary understanding of their companies' workings."[91]

The extent to which these developments limit the information available to modern public-company boards is unclear.[92] At a minimum, however, increased director independence suggests that while a board of directors is likely to continue to retain access to unique inside information, it seems factually obsolete to assume that the board cannot benefit from the different information that today's empowered shareholders may bring to the corporate decision-making process.

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83. *See* Gordon, *supra* note 27, at 1475 (noting that between 1950 and 2005, the percentage of independent directors increased from approximately 20% to 75%).

84. Among others, these mechanisms include stock-exchange listing standards mandating director independence, Delaware courts' requirements, and pressure from corporate governance reformers—first "as part of the post-hostile bid settlement among institutional investors, managers, and boards" of the 1990s and then in the aftermath of the corporate scandals of the early 2000s. *Id.* at 1468, 1477.

85. Stephen M. Bainbridge & M. Todd Henderson, *Boards-R-Us: Reconceptualizing Corporate Boards*, 66 STAN. L. REV. 1051, 1064–65 (2014).

86. *Id.*

87. COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD 45 (2004).

88. *Cf.* Yaron Nili, *Horizontal Directors*, 114 NW. U. L. REV. (forthcoming 2020) (manuscript at 2–3), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438281 [https://perma.cc/EBG6-RDU9] (arguing that current and former directorships in the same industry may have anticompetitive effects).

89. Bainbridge & Henderson, *supra* note 85, at 1066.

90. CARTER & LORSCH, *supra* note 87, at 45.

91. *Id.*

92. *See* Bainbridge & Henderson, *supra* note 85, at 1065–66 (noting the various reasons for information asymmetry between independent directors and inside managers).

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C. A Taxonomy of Shareholder Collaboration

Both large institutional investors (such as mutual funds and pension funds) and hedge funds increasingly engage in collaboration with corporate insiders. Conceptually, however, collaboration differs between these two investor groups. Hedge funds tend to engage in firm-specific operational collaboration through the proposal of business-strategy initiatives and often appoint one or more activist directors to supervise the implementation of those initiatives. Large institutional investors collaborate in ways that scale across multiple companies and broad themes, including takeover defenses, executive compensation structures, public policy issues, and regulatory matters.

Further, the spectrum of shareholder collaboration presents significant variation. Collaboration can take place both within and outside the institutional structure of the corporation, have an explicit or implicit contractual nature, and be advisory or binding. Collaboration thus emerges as a "continuous," rather than a "binary" choice.[93] This subpart examines the spectrum of shareholder collaboration and highlights some recent examples.

1. Hedge Funds and Constructivist Activism.—Activist hedge funds are usually portrayed as the prototypical corporate adversaries who seek to wrest board control, replace existing management, and engineer a structural or operational change. Yet hostile campaigns are not the exclusive form of hedge fund activism. Instead, the structure of these campaigns varies, sometimes substantially, depending on the fund's specific business model and temperament of its managers; the target's response; whether the fund seeks the replacement of the entire board or, more typically, only a partial slate; and whether it can count on the support of the company's institutional investors.[94] In particular, hedge funds are increasingly embracing a more "constructivist," longer-term kind of activism.[95]

A constructivist activist, as put by Leo Strine:

> may need to knock a bit loudly, but once let in, assumes the duties and economic consequences of becoming a genuine fiduciary with duties to other stockholders and of holding its position for a period of five to ten years, during which it is a constructive participant in helping the rest of the board and management improve a lagging company.[96]

93. A binary choice is one where the alternatives are yes or no, acceptance or rejection. A continuous choice, instead, is one between a set of differently preferred alternatives. *See, e.g.*, THOMAS C. SCHELLING, MICROMOTIVES AND MACROBEHAVIOR 213–14 (1978) (providing examples of common binary-choice problems).

94. *See* WALKER, *supra* note 77, at 30–37 (describing the typical structure of activist campaigns).

95. *See id.* at 13–17 (describing strategies of Nelson Peltz, Ralph Whitworth, and Jeffrey Ubben, all of whom practice a collaborative form of activism).

96. Strine, *supra* note 42, at 1908.

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Constructivist activism is best understood as shareholder collaboration. A constructivist hedge fund combines industry knowledge with a deep dive into firm-specific information, researching its target and developing a strategic agenda. The hedge fund typically incorporates this research into a detailed presentation or white paper that communicates the hedge fund's information both to the board and to other shareholders.[97] Whether through a short-slate-election contest or, more commonly, a settlement agreement, the hedge fund obtains board representation and uses that representation to work within the existing board to oversee the incorporation of its information into operational decisions for the purpose of improving firm performance.[98]

Viewed through this lens, the rise of settlement agreements granting the activist negotiated board representation is an important component of the shift from confrontation to collaboration.[99] The number of activist representatives serving as directors continues to grow—activists obtained 616 board seats since 2013.[100] Only a small percentage of these directors obtained their positions through full election contests; most activist representatives obtained board seats through a negotiation with the issuer outside the proxy-contest process.[101] Activists obtained more board seats in the first quarter of 2018 than all of 2017.[102] Moreover, more than 85% of the seats in Q1 2018 were obtained by settlement rather than through a proxy fight.[103]

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97. *See, e.g.*, *Hedge Funds*, SAVVY INVESTOR, https://www.savvyinvestor.net/alternative-asset-classes/hedge-funds/articles-and-white-papers [https://perma.cc/2FDP-PAAL] (featuring a collection of white papers).

98. *See, e.g.*, M&A TEAM, J.P. MORGAN, THE 2017 PROXY SEASON: GLOBALIZATION AND A NEW NORMAL FOR SHAREHOLDER ACTIVISM 10–12 (2017) (documenting the growth of activist campaigns focused on cost-cutting and strategic direction, as opposed to M&A objectives).

99. *See* WALKER, *supra* note 77, at 36 (reporting that 45.5% of U.S. activist campaigns ended in a "truce" between 2010 and 2015); Lucian A. Bebchuk et al., *Dancing with the Activists* 4 (European Corp. Governance Inst., Finance Working Paper No. 604, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2948869 [https://perma.cc/MZX8-SG32] (documenting evidence of a sevenfold increase in settlement agreements between 2000 and 2013); John C. Coffee, Jr., *The Agency Cost of Activism: Information Leakage, Thwarted Majorities, and the Public Morality* 9 (European Corp. Governance Inst., Law Working Paper No. 373, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3058319 [https://perma.cc/Z4PY-52AZ] (reporting data from Lazard that 95% of the record 131 board seats obtained by activist hedge funds in 2016 were the result of a settlement agreement).

100. LAZARD, REVIEW OF SHAREHOLDER ACTIVISM - 1Q 2018, at 5 (2018), https://www.lazard.com/media/450557/lazard-1q-2018-activism-review.pdf [https://perma.cc/BW9C-DLDA].

101. LAZARD, 2017 ACTIVISM YEAR IN REVIEW 5 (2018), https://www.lazard.com/media/450414/lazards-review-of-shareholder-activism-q4-2017pdf.pdf [https://perma.cc/H6KT-54GS] (reporting that 64% of board seats won by activists in 2017 occurred outside the proxy process).

102. LAZARD, REVIEW OF SHAREHOLDER ACTIVISM - 1H 2018, at 1 (2018), https://www.lazard.com/media/450655/lazards-review-of-shareholder-activism-1h-2018.pdf [https://perma.cc/T9H5-URT2].

103. *Id.*

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These settlements between activists and issuers have a number of features.[104] They typically include a standstill agreement in which the activist agrees not to engage in hostile activity as well as to adhere to additional restrictions.[105] They often contemplate a long-term engagement between incumbent directors and activist nominees.[106] Although board representation may still simply be a means to exploring a sale or other structural changes, many activist directors are retaining their board seats for multiple years[107] and focusing their attention on business strategy and other operational issues.[108] In similar circumstances, settlement agreements are likely to promote an environment in which activist-appointed directors—similar to constituency directors in the VC context—work alongside incumbents as colleagues to effect changes in a collaborative rather than confrontational manner.[109]

Further, while constructivist activists have traditionally represented the minority numerically (relative to hit-and-run, hostile activists), both the empirical and anecdotal evidence point to substantial growth in this form of activism.[110] Commentators now suggest that collaborative engagement could dominate hostile engagement in the future.[111] In an article published in

104. *See generally* Francis J. Aquila, *Negotiating a Settlement with an Activist Investor*, PRAC. L.J.: TRANSACTIONS & BUS., Apr. 2015, at 22, https://www.sullcrom.com/files/upload/Apr15_InTheBoardroom.pdf [https://perma.cc/2TJU-2PQQ] (describing common provisions in settlement agreements with activist investors).

105. *See, e.g.*, Derek D. Bork, *Settlement Agreements with Activist Investors—the Latest Entrenchment Device?*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 7, 2016), https://corpgov.law.harvard.edu/2016/07/07/settlement-agreements-with-activist-investors-the-latest-entrenchment-device/ [https://perma.cc/MW4G-4ZVZ] (describing common restrictions imposed by settlement agreements on activists in connection with negotiated board representation).

106. For example, some companies require activist-appointed directors to "sign and pre-deliver director resignations that are automatically triggered when the board decides that the representative has breached the settlement agreement." *Id.*

107. *See, e.g.*, Ian D. Gow, Sa-Pyung Sean Shin & Suraj Srinivasan, *Activist Directors: Determinants and Consequences* 13 (Harvard Bus. Sch., Working Paper No. 14-120, 2014), https://www.hbs.edu/faculty/Publication%20Files/14-120_451759fe-d298-4072-81d1-b007fd4d5bc0.pdf [https://perma.cc/3J5P-FPZL] (reporting average tenure, as of 2013, of two years for activist directors who had left the board and nearly four years for directors who are still on the board).

108. *See also* Ethan A. Klingsberg & Elizabeth Bieber, *Activism in 2018*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 29, 2018), https://corpgov.law.harvard.edu/2018/01/29/activism-in-2018/ [https://perma.cc/G74V-5B5V] (observing that "[t]he activists are now regularly holding investments for four to five years and focusing more consistently during the initial years of their investments on advocating for operational turnarounds").

109. Ira Millstein makes a convincing case for constructive activism in his recent book. *See generally* IRA MILLSTEIN, THE ACTIVIST DIRECTOR (2017).

110. *See* C.N.V. Krishnan et al., *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296, 310–11 (2016) (providing empirical evidence that the most successful activists have been capable of taking large stakes, gaining board seats, and staying in a corporation for longer periods of time); Shill, *supra* note 8, at 1254, 1262–63 (describing a "dynamic of boards and activists . . . edging unmistakably towards collaboration" and providing anecdotal evidence supporting this conclusion).

111. *See, e.g.*, WALKER, *supra* note 77, at 230.

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February 2018, the Financial Times spoke of a new class of "sons of activists," which includes several former portfolio managers of more established, hostile hedge funds.[112] This new generation of activists is "eschewing the public dispute and open confrontation" of the older guard and is instead "eager to work with management behind the scenes and to hold positions for longer."[113]

ValueAct's involvement with Microsoft offers a high-profile example of constructivist activism.[114] In 2013, ValueAct researched Microsoft for months, concluding that the company suffered from a "perception problem."[115] Most investors believed that the company's profits came largely from the sale of operating systems and personal computers.[116] The declining PC market thus suggested that Microsoft's prospects were not good.[117] ValueAct instead believed the company's strength lay in other services, such as the company's Office suite of products and Outlook email system.[118]

After some behind-the-scenes contacts, the parties signed a standstill agreement, under which ValueAct obtained a board seat in exchange for desisting from a potential proxy fight—de facto choosing a collaborative scheme over a competitive one.[119] Following the signing of the standstill agreement, Microsoft implemented several of the suggestions made by ValueAct (including the appointment of a new CEO).[120] Meanwhile, the share price of Microsoft rose considerably.[121]

Commenting on the success of the venture, ValueAct's Morfit Mason remarked that Microsoft is not the usual hedge fund story of:

> battles, victors, and losers . . . . It's actually about re-examining all of the premises on which a 40-year-old icon was built and discarding the ones that don't make sense in this world and driving toward the ones that do. You can trace all of the actions that have happened at Microsoft to that fundamental attitude. Not necessarily to us, but Microsoft re-examining all of its fundamental beliefs.[122]

ValueAct's investment in Microsoft was a long-term one. Mason sat on the Microsoft board, and ValueAct held a substantial quantity of Microsoft

112. Lindsay Fortado, *Investing: Activism Enters the Mainstream*, FIN. TIMES (Feb. 13, 2018), https://www.ft.com/content/e04547b8-0d0b-11e8-839d-41ca06376bf2 [https://perma.cc/A2TC-UQYP].

113. *Id.*

114. *See* WALKER, *supra* note 77, at 145–55.

115. *Id.* at 146.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.* at 150–51.

120. *Id.* at 153–54.

121. *Id.* at 155.

122. *Id.* (quoting Mason).

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stock through 2017.[123] During this time, Microsoft's stock price continued to increase.

The 94-page white paper released by Nelson Peltz's Trian Fund—another fund with a well-established reputation for constructivist activism—in the recent engagement at Procter & Gamble (P&G)[124] provides another salient example. Trian's white paper made it clear that the fund was seeking to add Peltz to the P&G board in order to create "sustainable long-term value at P&G"[125] and not seeking to replace P&G's CEO or any other "classic" disciplinary outcomes sought by hostile activists.[126] At least on paper, Trian was seeking a collaborative rather than a competitive interaction with the P&G board, one designed to add knowledge rather than to have the board fired.[127] Concededly, the P&G board strongly opposed Trian's intervention, which led to one of the most expensive proxy contests in history.[128] In the end, however, P&G shareholders narrowly supported Peltz's candidacy.[129] It is also noteworthy that even after P&G conceded defeat, Peltz continued to profess his intention not to disrupt the board's operations but to "work[] collaboratively with [P&G's CEO] and the rest of the board to drive sustainable long-term shareholder value."[130]

Trian's recent intervention in another classic American brand, General Electric Company (GE), presents even clearer collaborative features. This time, the company itself initiated the collaboration; GE's CEO invited Trian to invest in the company and become active in reforming it.[131] That Trian had

123. *See ValueAct Capital Reduces Microsoft Stake*, MARKET FOLLY (Aug. 9, 2017), http://www.marketfolly.com/2017/08/valueact-capital-reduces-microsoft-stake.html [https://perma.cc/U7NS-25BA] (reporting ValueAct's sale of seven million Microsoft shares in 2017).

124. TRIAN PARTNERS, REVITALIZE P&G TOGETHER, VOTE THE WHITE PROXY CARD (2017), http://www.wlrk.com/docs/Trian-PG-White-Paper-9_6_17.pdf [https://perma.cc/RN6S-C6T6].

125. *Id.* at 4.

126. Martin Lipton, *The Trian/P&G Proxy Contest*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Sept. 11, 2017), https://corpgov.law.harvard.edu/2017/09/11/the-trianpg-proxy-contest/ [https://perma.cc/F9EB-HRXL].

127. *See, e.g.*, Shawn Tully, *Three Reasons Why P&G Should Put Nelson Peltz on Its Board*, FORTUNE (Oct. 4, 2017), http://fortune.com/2017/10/04/pg-trian-proxy-battle/ [https://perma.cc/4386-SENA] (arguing that shareholders should support Peltz because of weaknesses in P&G's operational strategy that might be remedied by "a consumer goods veteran who's betting billions that new thinking can revive a flagging American icon").

128. Chris Isidore & David Goldman, *Procter & Gamble Declares Victory in Expensive Proxy Fight*, CNN MONEY (Oct. 10, 2017), http://money.cnn.com/2017/10/10/news/companies/procter-gamble-proxy-fight/index.html [https://perma.cc/M7W2-RD47] (describing the contest as "the most expensive in U.S. corporate history").

129. *See* Nick Turner & Beth Jinks, *P&G Names Activist Nelson Peltz to Board After Proxy Battle* (Dec. 15, 2017), https://www.bloomberg.com/news/articles/2017-12-15/p-g-names-billionaire-nelson-peltz-to-board-after-proxy-battle [https://perma.cc/4SPR-WD9P] (reporting that Peltz won by fewer than 43,000 shares).

130. *Id.*

131. Andrew Ross Sorkin, *Why Nelson Peltz Wants P&G to See Him as a 'Constructivist*,*'* N.Y. TIMES: DEALBOOK (July 17, 2017), https://www.nytimes.com/2017/07/17/business/dealbook/nelson-peltzs-play-for-pampg-honorable-intentions.html [https://perma.cc/ACZ7-YE7Z].

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knowledge unavailable to GE was implicit in that request. At the same time, as noted by one commentator, the request would arguably not have materialized if Trian had not developed a reputation "for working behind the scenes with management to improve performance . . . [and sticking] around, often for years, as transformations occur."[132]

On the front of the new generation of the "sons of activists," up-and-coming D.E. Shaw & Co. made news in early 2018 for gaining three board seats at Lowe's, the giant home-improvement chain.[133] The appointment of D.E. Shaw's activist directors took place after a settlement that Lowe's management described as involving "constructive discussions" with the fund.[134] Significantly, the entire campaign was kept private until the settlement.[135] According to industry watchers, this circumstance underlines the change in the approach of the new generation of activists, which are "not just less confrontational in public, but also easier to work with behind the scenes."[136] Whereas the older guard would pressure or even intimidate incumbents into effecting desired changes, the new guard is not "going to try to intimidate anyone."[137] Instead, they are trying to collaborate with insiders.

Lastly, activist hedge fund Elliott Management, a fund commonly associated with confrontation, recently disclosed that it has been engaged for months in talks with the management of SAP SE, in which Elliott has a $1.4 billion stake.[138] According to SAP management, the two are working on "new initiatives to accelerate operational excellence and value creation."[139]

2. Mutual and Pension Fund Engagement.—A substantial proportion of large institutional investors such as mutual funds and pension funds are committed investors in the sense that they do not or cannot readily sell their stock if they disagree with managers' operational decisions.[140] This commitment creates both an incentive for them to invest in generating firm-specific information and an assurance to managers that the concerns that the investors bring to the dialogue are not the product of short-term strategies.[141]

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132. Geoffrey Smith, *GE Just Caved and Put One of Nelson Peltz's Colleagues on Its Board*, FORTUNE (Oct. 10, 2017), http://fortune.com/2017/10/10/ge-just-caved-and-put-one-of-nelson-peltzs-colleagues-on-its-board/ [https://perma.cc/6JQV-D4EB].

133. Fortado, *supra* note 112.

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.*

138. Eyk Henning, *SAP and Elliott Have Held Strategy Talks for Months*, BLOOMBERG (Apr. 24, 2019, 5:05 AM), https://www.bloomberg.com/news/articles/2019-04-24/sap-elliott-are-said-to-have-held-strategy-talks-for-months [https://perma.cc/KJD7-FCFU].

139. *Id.*

140. *See* Fisch et al., *supra* note 81, at 56–57 (explaining that so-called passive investors cannot exit by selling their stock).

141. *See id.* at 52 (observing that passive investors do not benefit from strategies that generate short-term gains at the expense of long-term value).

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Collaboration between large institutional investors and corporate insiders, however, differs from hedge fund collaboration in both form and substance. Institutional investors do not typically seek board representation.[142] Nor do they engage in the level of detailed research and firm-specific analysis that characterizes hedge fund campaigns.[143] Instead, large institutions collaborate through various forms of "engagement,"[144] which operationalizes a dialogical process[145] about matters of concern.[146] In particular, engagement tends to focus on market-wide or industry-wide issues such as governance, sustainability, and risk management,[147] as the size of institutional investors places them in a unique position to enjoy economies of scale and observe trends across the companies in their portfolio that may supplement the perspective of firm insiders.

Engagement by institutional investors often results in changes at the involved companies, although these changes are the product of a consensus process between corporate insiders and institutional investors. For example, in a recent survey on the top successful engagement outcomes, shareholders listed the promotion of additional company disclosures, the adoption of specific changes in company policies or business practices, and the company's commitment to act on issues of concerns in the future.[148]

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142. At least one corporation, UnitedHealth Group, has established an advisory committee to allow shareholders to suggest new directors. *Dangerous Talk? When/How Should Directors Communicate with Shareholders?*, LATHAM & WATKINS LLP (Latham & Watkins LLP, San Diego, Cal.), at 2, https://www.yumpu.com/en/document/read/52351925/1-dangerous-talk-when-how-should-directors-communicate-with- [https://perma.cc/QA44-PSW6]. John Coffee has proposed that a steering committee of institutional investors in charge of assembling a team of outside directors in case of an activist attack could provide an effective solution to the problems raised by hedge-fund-appointed directors. Coffee, *supra* note 99, at 26.

143. *See, e.g.*, SHARON E. FAY, ALL. BERNSTEIN, THE MEGAPHONE EFFECT 3 (2018) https://www.alliancebernstein.com/sites/library/Instrumentation/FINAL_EQU-7697-0618.pdf [https://perma.cc/2UQU-H5PL] (noting that "index funds are noticeably absent from engagement based on fundamental research").

144. For a detailed description of shareholder engagement, see Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuk-Strine Debate*, 12 N.Y.U. J.L. & BUS. 385, 392–94 (2016).

145. The SEC has expressly indicated its support for increased communication between issuers and shareholders and offered "guidance on ways to enhance the ability of corporations to effectively and efficiently communicate with shareholders." Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 2013 U. ILL. L. REV. 821, 831 (2013).

146. *See* F. William McNabb III, *Getting to Know You: The Case for Significant Shareholder Engagement*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 24, 2015), https://corpgov.law.harvard.edu/2015/06/24/getting-to-know-you-the-case-for-significant-shareholder-engagement/ [https://perma.cc/M3BV-J4B6] (Vanguard CEO's detailed description of the practicalities of engagement).

147. PWC, DIRECTOR-SHAREHOLDER ENGAGEMENT 2 (2019), https://www.pwc.com/us/en/governance-insights-center/publications/assets/pwc-director-shareholder-engagement-getting-it-right.pdf [https://perma.cc/B4T2-CGFQ].

148. FOLEY & LARDNER LLP, SHAREHOLDER ENGAGEMENT AND PROXY ACCESS 15 (2016), https://www.foley.com/en/insights/events/2016/11/2016-ndi-executive-exchange [https://perma.cc/N2Q4-5T2P] (follow "Shareholder Engagement and Proxy Access" dropdown menu; then follow "Program Materials"). Do we really need these "indications"?

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Engagement can take a wide range of forms, from private "one-on-one" meetings[149] to periodic investor days,[150] investor relations contacts,[151] industry conference presentations,[152] a variety of online communication tools,[153] as well as letters and phone calls.[154] Several companies have also adopted "shareholder engagement policies," which are designed to provide structured interaction guidelines for engagement—including on the frequency, methods, and topics of insider–shareholder interaction.[155] Along similar lines, some boards have established "engagement committees," which are permanently charged with managing the shareholder-engagement process.[156]

Attesting to the mounting importance of shareholder engagement, a recent survey found that 63% of large institutional investors have engaged in direct discussions with management over the past five years, and 45% had private discussions with a company's board outside of management presence.[157] And while just 6% of S&P 500 companies reported investor

149. Deloitte, *Shareholder Engagement: A New Era in Corporate Governance*, WALL ST. J.: RISK & COMPLIANCE J. (Oct. 1, 2013, 12:01 AM), https://deloitte.wsj.com/riskandcompliance/2013/10/01/shareholder-engagement-a-new-era-in-corporate-governance/ [https://perma.cc/MTT8-679A].

150. Fairfax, *supra* note 146, at 831.

151. Matteo Tonello, *Global Trends in Board-Shareholder Engagement*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 25, 2013), https://corpgov.law.harvard.edu/2013/10/25/global-trends-in-board-shareholder-engagement/#more-53945 [https://perma.cc/X97R-HREK].

152. *Id.*

153. *Id.*; *see also What's New in Shareholder Engagement: Telling Your Own Story*, NASDAQ (June 22, 2017), https://listingcenter.nasdaq.com/Material_Search.aspx?cid=130&mcd=CH [https://perma.cc/PTC7-SF2K] (describing shareholder engagement through online interactive proxy statements).

154. Fisch et al., *supra* note 81, at 48 (reporting that "[i]n recent years . . . . [m]utual funds have increasingly made direct contact—by letter, phone, electronic communication, and direct meetings—with the officers and directors of their portfolio companies").

155. *See, e.g.*, CHAPMAN & CUTLER LLP, CONSIDERING A SHAREHOLDER ENGAGEMENT POLICY—THE WHAT, WHY AND HOW 2–4 (2016), https://www.chapman.com/media/publication/689_Chapman_Considering_Shareholder_Engagement_Policy_092916.pdf [https://perma.cc/P7DL-PMH2] (identifying "best practices" for implementation of a shareholder engagement policy).

156. FOLEY & LARDNER LLP, *supra* note 148, at 9; *see also* Press Release, Tempur Sealy, Tempur Sealy Announces Leadership and Board Changes (May 11, 2015), http://investor.tempursealy.com/news-releases/news-release-details/tempur-sealy-announces-leadership-and-board-changes [https://perma.cc/YLE3-CCM8] (announcing the creation of "a new Stockholder Liaison Committee, in order to create a Board-level structure for communication and engagement between the Board and stockholders and to enhance the existing stockholder communications process led by the Company's management"); Letter from F. William McNabb III, Chairman & CEO, Vanguard, to Independent Leaders of the Boards of Directors of the Vanguard Fund's Largest Portfolio Holdings (Feb. 27, 2015), https://pcg.law.harvard.edu/wp-content/uploads/2016/09/7-CEO_Letter_03_02_ext.pdf [https://perma.cc/93SV-8RDZ] (explaining that "'shareholder liaison committee[s]' . . . can provide an appropriate structure for communicating with significant shareholders").

157. Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2906 (2016).

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engagement in 2010, engagement figures rose to 72% as of June 2017.[158] The numbers for BlackRock and Vanguard are especially telling. From mid-2014 to mid-2015, BlackRock performed over 1,500 private "engagements" with companies held in their portfolio, and Vanguard had over 800 company engagements.[159]

Besides engagement, examples of collaborative initiatives by institutional investors continue to emerge. On August 31, 2017, for instance, Vanguard released a letter to investors pushing for a two-way dialogue with corporations and reaffirming the importance of building "relationships with boards and management teams."[160] Only eight days later, on September 8, 2017, Scott Stringer, the New York City Comptroller who manages the New York City Pension Funds, released a similar letter to the boards of 151 companies requesting a meeting with these companies' directors to discuss matters such as director criteria, diversity, and skillsets, and their linkage to the companies' needs and risks.[161] Similarly, in June 2018, T. Rowe Price issued a statement emphasizing that the firm's "ability to generate unique insights about companies" reflected the additional "ability to cultivate constructive, private, two-way communication" with company management teams.[162]

Further, engagement does not just occur at the individual company level. Both investors and issuers are participating in a growing number of private initiatives aimed at promoting insider–shareholder collaboration on a variety of issues and, in particular, corporate governance matters.[163] One of the first such initiatives was the "Shareholder-Director Exchange Program" (SDX), a

158. Mark Manoff & Stephen W. Klemash, *2017 Proxy Season Review*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 9, 2017), https://corpgov.law.harvard.edu/2017/07/09/2017-proxy-season-review/ [https://perma.cc/9TV4-5E74]. Among others, a company's responsiveness to shareholder requests for engagement has also become one of the fundamental evaluation criteria used by the Institutional Shareholder Service (ISS) in recommending votes on a variety of governance topics, which might be one of the factors behind the increase in shareholder engagement. FOLEY & LARDNER LLP, *supra* note 148, at 5.

159. Fichtner et al., *supra* note 80, at 318.

160. Letter from F. William McNabb III, Chairman & CEO, Vanguard, to Directors of Public Companies Worldwide (Aug. 31, 2017), https://about.vanguard.com/investment-stewardship/governance-letter-to-companies.pdf [https://perma.cc/W9EE-33XP].

161. Press Release, N.Y.C. Comptroller, Comptroller Stringer, NYC Pension Funds Launch National Boardroom Accountability Project Campaign—Version 2.0 (Sept. 8, 2017), https://comptroller.nyc.gov/newsroom/press-releases/comptroller-stringer-nyc-pension-funds-launch-national-boardroom-accountability-project-campaign-version-2-0/ [https://perma.cc/VC3L-ZDSV].

162. T. ROWE PRICE, T. ROWE PRICE'S INVESTMENT PHILOSOPHY ON SHAREHOLDER ACTIVISM 1 (2018), http://www.wlrk.com/docs/trowepriceesgspotlightjune2018.pdf [https://perma.cc/VKN5-4BCS].

163. Shareholders are also participating in coordinated engagements. *See, e.g.*, Elroy Dimson, Oguzhan Karakas & Xi Li, Coordinated Engagements 2 (Dec. 24, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3209072 [https://perma.cc/WXB8-HRS8] (describing coordinated engagements by investors seeking to influence issuers on environmental and social issues).

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private organization established in 2014 by representatives of major U.S. corporations and big institutional investors like BlackRock and Vanguard.[164] The SDX's aim is promoting a voluntary template for healthy relations between shareholders and boards as well as regular and successful engagement on matters such as corporate governance, management changes, and long-term plans.[165] Importantly, in defining successful engagement, the SDX's protocol includes as essential "each party's willingness to listen carefully to one another and to take action in response to valid concerns."[166] That is, each party's willingness to collaborate with the other is crucial within the SDX framework.[167]

Along similar lines, in 2016, representatives of major U.S. corporations and major investors (including Blackrock, Vanguard, and ValueAct) signed a paper calling for new commonsense principles of corporate governance, principles that build on a constructive dialogue among the involved parties.[168] In 2017, a collective of U.S.-based institutional investors and global asset managers[169] launched the "Investor Stewardship Group" (ISG), with the aim of improving cooperation among companies, large investors, and shareholders.[170] The same year the International Business Council of the

164. Linette Lopez, *A New Group Has Declared War on the Carl Icahns of the World*, BUS. INSIDER (Feb. 3, 2014, 9:13 AM), https://www.businessinsider.com/shareholder-director-exchange-2014-2 [https://perma.cc/9RX7-RVBF]; *see also* SDX, THE SHAREHOLDER-DIRECTOR EXCHANGE: INTRODUCTION AND PROTOCOL 1 (2014), http://www.sdxprotocol.com/wp-content/uploads/2015/04/SDX_Introduction-and-Protocol.pdf [https://perma.cc/4TFV-BHAE] (explaining the rationale for and setting forth a ten-point protocol offering issuers and shareholders guidance on when to engage and how to make those engagements valuable).

165. David Gelles, *Unlikely Allies Seek to Check Power of Activist Hedge Funds*, N.Y. TIMES: DEALBOOK (Feb. 2, 2014, 10:01 PM), https://dealbook.nytimes.com/2014/02/02/unlikely-allies-seek-to-check-power-of-activist-hedge-funds/ [https://perma.cc/KF9P-BNCG]. In the words of one SDX member, the SDX developed in the belief that "[s]hareholders and the boards that serve them need to be closer, they need to be more integrated, and there need to be real relationships." *Id.* (quoting James C. Woolery, the chairman-elect of Cadwalader).

166. *Id.* (quoting SDX protocol).

167. Consistent with the increasingly proactive approach to engagement taken by both investors and corporations, the SDX meetings—as observed by a founding member—"have to have a purpose . . . . It isn't just about everyone getting to know one another." *Id.* (quoting Michelle Edkins of BlackRock).

168. *Open Letter: Commonsense Principles of Corporate Governance*, COMMONSENSE CORP. GOVERNANCE PRINCIPLES, https://www.governanceprinciples.org/wp-content/uploads/2018/10/2016-Open-Letter-Principles.pdf [https://perma.cc/EM2X-W6X6]. Among other governance matters, the commonsense principles cover the composition, election, compensation, and tenure of directors; the communication process between the board and the investors; shareholder rights; public reporting and management compensation; and succession planning. *Id.*

169. Anne Meyer, Don Cassidy & Rajeev Kumar, *The Investor Stewardship Group's Governance Principles*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 11, 2018), https://corpgov.law.harvard.edu/2018/05/11/the-investor-stewardship-groups-governance-principles/ [https://perma.cc/F69Y-QVE2].

170. David A. Katz & Laura A. McIntosh, *Common-Sense Capitalism*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 28, 2017), https://corpgov.law.harvard.edu/2017/07/28/

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World Economic Forum approved "The New Paradigm," a programmatic framework that "conceives of corporate governance as a collaboration among corporations, shareholders and other stakeholders,"[171] with the expectation that institutional investors will "work to understand corporations' strategies and operations and engage with them to provide corporations with opportunities to understand the investors' opinions and to adjust strategies and operations in order to receive the investors' support."[172]

Investors' common ownership—the fact that many institutional investors own "significant stakes in multiple firms in the same industry"[173] —also enhances their incentives to collaborate with corporate insiders. Common ownership gives investors a comparative advantage relative to firm management in acquiring information that may be of value to several of their portfolio companies—such as information about macroeconomic trends, evolving legal risks, and developing market norms. Investors are increasingly choosing to use this advantage *with*, rather than *against*, management. An example is the recent efforts by several large institutional investors to work with their portfolio companies to promote increased attention to sustainability issues. Thus, last year, BlackRock, Vanguard, and State Street led efforts to induce Exxon management to devote greater attention to—as well as adopt greater disclosure and transparency about—the risks associated with climate change.[174]

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common-sense-capitalism/ [https://perma.cc/X2GK-GGJ3]; *see also* John C. Wilcox, *The Investor Stewardship Group: An Inflection Point in U.S. Corporate Governance?*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 30, 2017), https://corpgov.law.harvard.edu/2017/03/30/the-investor-stewardship-group-an-inflection-point-in-u-s-corporate-governance/ [https://perma.cc/4UUW-3RUQ] (noticing the overlap between the ISG member firms and signatories to the Commonsense Principles of Corporate Governance). The ISG plans to achieve this goal by providing a "set of elementary corporate governance principles for U.S. listed companies . . . as well as parallel stewardship principles for U.S. institutional investors." Meyer et al., *supra* 169. From this Article's perspective, what is noteworthy about the ISG principles is that they endorse a "comply-or-explain" approach, which is intended to provide companies with the necessary flexibility to adopt tailored, collaborative solutions. *Id.*

171. Martin Lipton, *Corporate Governance: The New Paradigm*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 11, 2017), https://corpgov.law.harvard.edu/2017/01/11/corporate-governance-the-new-paradigm/ [https://perma.cc/3R9U-74BE]; *see also* WORLD ECON. FORUM, ANNUAL REPORT 2016 - 2017, at 44 (2017), http://www3.wefrum.org/docs/WEF_Annual_Report_2016_17.pdf [https://perma.cc/N2WU-KG3X].

172. Lipton, *supra* note 171.

173. Asaf Eckstein, *The Virtue of Common Ownership in an Era of Corporate Compliance*, 105 IOWA L. REV. 507, 509 (2020).

174. *See* Steven Mufson, *Financial Firms Lead Shareholder Rebellion Against ExxonMobil Climate Change Policies*, WASH. POST (May 31, 2017, 3:30 PM), https://www.washingtonpost.com/news/energy-environment/wp/2017/05/31/exxonmobil-is-trying-to-fend-off-a-shareholder-rebellion-over-climate-change/?noredirect=on&utm_term=.9160808b20a6 [https://perma.cc/98A3-C34B] (citing an unnamed source as indicating that BlackRock, likely along with Vanguard and State Street, voted to support a shareholder proposal requesting management reporting about climate change).

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Large institutional investors also have privileged access to legal and regulatory policy. As Asaf Eckstein documents, institutional investors are increasingly invited to comment on regulatory initiatives at a preproposal stage and to engage in a dialogue with policymakers.[175] This access both enables investors to influence regulatory policies in ways that may benefit their portfolio companies and provides them early insights into potential regulatory changes that may require firms to adapt their operational policies.

Finally, institutional investors serve a critical gatekeeping role with respect to hedge fund activism. It is well known that, because of their relatively small stakes, activists need the support of passive investors to be successful, support that in the past they have frequently been able to secure.[176] In recent years, however, institutional investors have taken a more nuanced view of activist interventions.[177] On the one hand, they have increasingly withheld support of activists who primarily seek to force companies into share buybacks, extraordinary distributions, and other short-term "cut and run" strategies,[178] which are incompatible with the longer investment horizon of institutional investors. On the other hand, institutional investors have remained willing to support activists that are committed to long-term value through collaboration.[179] Further, institutional investors' ability to function as the marginal voters in activist campaigns strengthens their effectiveness in ongoing engagement. Managers increasingly recognize that the support of institutional investors is a valuable defense to potentially hostile interventions and, as a result, have become more willing to engage with investors, build relationships, and respond to their concerns.[180]

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175. Eckstein, *supra* note 172, at 47–48.

176. *See* Gilson & Gordon, *supra* note 72, at 866–67 (explaining that activists need the support of traditionally passive investors).

177. *See* Simone M. Sepe, *Board and Shareholder Power, Revisited*, 101 MINN. L. REV. 1377, 1440–41 (2017) (reporting that institutional investors have recently begun, in some cases, to support companies against activist interventions).

178. *See* Andrew Ross Sorkin, *BlackRock's Chief, Laurence Fink, Urges Other C.E.O.s to Stop Being so Nice to Investors*, N.Y. TIMES: DEALBOOK (Apr. 13, 2015), https://www.nytimes.com/2015/04/14/business/dealbook/blackrocks-chief-laurence-fink-urges-other-ceos-to-stop-being-so-nice-to-investors.html [https://perma.cc/L5H2-34NP] (discussing the concerns expressed by Larry Fink, the CEO of BlackRock, about short-termist hedge fund activism).

179. As Larry Fink explained in BlackRock's 2016 letter to CEOs, "activists who focus on long-term value creation sometimes do offer better strategies than management. In those cases, BlackRock's corporate governance team will support activist plans." Matt Turner, *Here Is the Letter the World's Largest Investor, BlackRock CEO Larry Fink, Just Sent to CEOs Everywhere*, BUS. INSIDER (Feb. 2, 2016, 7:03 AM), http://www.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-2 [https://perma.cc/ZYX2-RDAX].

180. *See, e.g.*, Peter Michelsen & Derek Zaba, *The Rise of Investor-Centric Activism Defense Strategy*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 25, 2017), https://corpgov.law.harvard.edu/2017/10/25/the-rise-of-investor-centric-activism-defense-strategy/ [https://perma.cc/Q6JV-UWYX] ("[T]he right approach for companies is to 'think like a shareholder representative': engage with investors, understand and incorporate their perspectives, and educate them on why the company is pursuing a particular strategy, particularly before an activist appears.").

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III. Defending and Structuring the Collaborative Model

Part II explained that the insider–shareholder dynamic in the public corporation is increasingly collaborative, rather than competitive, as argued by the defendants of the traditional models of the corporation. It also suggested that collaboration is a response to the informational changes that have occurred in corporate production and the role of shareholders, changes under which partial information problems have, for many firms, grown costlier than agency problems.

In this Part, we use insights from both epistemic models of collective wisdom and the economics of information to defend the normative desirability of the collaborative model. We do this through the following steps. In subpart A, we explain that the partial information of investors and insiders is likely to be complementary, so that the informational whole resulting from the aggregation of insider and shareholder information is greater than the sum of its parts. In subpart B, we show that collaboration provides a mechanism for efficiently combining the partial and complementary information of insiders and shareholders, a mechanism that neither unilateral decision-making nor the mediated transmission of information through markets can provide. In subpart C, we offer an illustration to make the value-increasing properties of shareholder collaboration more tangible. Lastly, in subpart D, we discuss how the rules of the collaborative "game" should be designed to ensure that collaboration is compatible with the *individual* incentives of directors, managers, and shareholders.

A. The Value of Collaboration

1. Information Complementarity.—As we discussed above, the value of collaboration flows from the aggregation of the partial information that insiders and shareholders possess in a world of complex investments and reconcentrated equity ownership. We argue that the source of this added value stems from the fact that the partial information supplied by shareholders and insiders is likely to be "complementary" in nature.

Information is *complementary* when the possession of one piece of information increases the marginal value of acquiring the second piece so that the informational whole is greater than the sum of its parts.[181] Complementary information is to be distinguished from *substitute* information. Information is substitute if the possession of one piece of information decreases the marginal value of acquiring another piece of information.[182] In essence, information that is relatively similar tends to be

181. Matthew C. Stephenson, *Information Acquisition and Institutional Design*, 124 HARV. L. REV. 1422, 1467 (2011).

182. *Id.*

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substitute, as the second piece of information does not contribute much to the preexisting knowledge.

Cognitive models help explain why corporate insiders and shareholders are likely to possess complementary rather than substitute information. These models distinguish between *interpretative* signals and the standard *generated* signals of statistical collective-wisdom models.[183] "Generated" signals are the result of a random variable drawn from a distribution.[184] For example, in the corporate context, observed sales of a new product send a generated signal about whether the product is of good quality. Generated signals, however, do not capture the fact that agents both receive signals and also interpret them, determining their meaning in light of other information, experience, and expertise. Thus, an agent might use its knowledge of the market, consumer needs, or past sales to determine whether the signal it receives from the sales of a new product is about customers' reactions to the product's quality or its price. Interpreting this signal correctly allows managers to make appropriate operational decisions about the future of the product. The role of interpretation may also induce firm decision-makers to search for a different kind of information than that provided by the sales of the product alone.

Cognitive models of collective wisdom seek to capture this richer signaling structure through the concept of "interpreted" signals. Unlike generated signals, which are passively received by the agents, interpreted signals result from the agents' "active cognitive effort."[185] That is, to create an interpreted signal, an agent uses an interpretative model that filters reality into a set of categories and then uses these categories to make predictions about the variable of interest.[186] Under this richer cognitive structure, what matters for the ability of a collection of agents to produce more accurate predictions than a single agent in isolation are the characteristics of the agents' interpretative models.

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183. Lu Hong & Scott Page, *Interpreted and Generated Signals*, 144 J. ECON. THEORY 2174, 2175 (2009).

184. More technically, Hong and Page explain generated signals as follows:

> For example, suppose the relevant issue concerns the status of a firm which can be classified as either "good" (G) or "bad" (B). Agents do not know the true status, but they have a common prior, say, $P(G) = P(B) = ½$. Each agent draws a binary signal, whose value is either g or b, from given distributions. Most often, these signals would be assumed to be drawn independently, i.e. their values would be independent conditional on the true status of the firm.

Id.

185. *Id.*

186. More formally, cognitive models begin by defining predictive problems as involving a set of possible states of the world X and an outcome function F, which maps each possible state of the world into a given outcome. Each individual's interpretation of the possible states of the world is then a partition of the set of states into distinct categories. Note that predictive models are coarser than the outcome function. Indeed, whereas the objective function maps states of the world into outcomes, predictive models map sets of states of the world, namely categories, into outcomes. *See id.* at 2176 (discussing the process of creating an interpretive signal in an interpretive model).

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Cognitive theory shows that these models need to be *sophisticated* and *diverse*.[187] The intuition can be grasped as follows. First, when agents use sophisticated interpretative models, they will tend to partition the set of possible states of the world into many categories (that is, more than when they use less sophisticated interpretative models). Second, when agents use diverse interpretative models, each individual will create a different partition of the possible states of the world.[188] As a result, signal heterogeneity (the production of different predictions) stems from cognitive diversity among sophisticated agents rather than randomness (as for generated signals).[189] It follows that information based on interpreted signals is more likely to be complementary, relative to information that is the result of generated signals.

The interpretive models of shareholders and insiders are particularly likely to be sophisticated and diverse and, hence, complementary. To begin with, board members are selected for their "institutional competence," which denotes both expertise and the ability to acquire and process information. Similarly, institutional shareholders, such as large mutual funds and hedge funds, are increasingly sophisticated, as they demonstrate a growing commitment to understanding the operations of their portfolio companies.

Because of insiders' access to private firm-specific information, their interpretative models can also realistically be assumed to be diverse from those used by shareholders. But diversity also is a defining feature of the investor crowd. Institutional investors such as pension and mutual funds have different business models and investment horizons than hedge funds.[190] Further, hedge funds themselves tend to have different business models and exhibit idiosyncratic features, especially when it comes to target selection.[191] Some hedge funds, for example, focus on targeting companies in certain industries; others are governance specialists.[192] Each fund follows a different template in deciding when moving on a company.[193] Indeed, investor diversity is quintessential to their ability to compete with each other. If investors shared the same business model, they would no longer have the prospect of delivering competitively superior performance.

The diversity of insider and investor perspectives, experiences, and objectives increases the likelihood that they bring not just different but also complementary information to firm decision-making. As a result, if a

187. Lu Hong & Scott E. Page, *Some Microfoundations of Collective Wisdom*, *in* COLLECTIVE WISDOM 56, 57 (Hélène Landemore & Jon Elster eds., 2012).

188. More analytically, diverse interpretative models tend to produce negatively correlated predictions and negatively correlated predictions produce better aggregate outcomes. *Id.* at 57–58.

189. Hong & Page, *supra* note 183, at 2175.

190. *See supra* section II(C)(2).

191. *See* WALKER, *supra* note 77, at 11–21 (comparing the business models and intervention strategies of the most important U.S. hedge funds).

192. *Id.*

193. *Id.*

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collaborative model provides a mechanism for aggregating that information, it can enable the firm to make better-informed decisions, thereby increasing firm value.

2. Aggregating Shareholder Information: Collaboration Versus Markets.—As used in this Article, collaboration contemplates a direct deliberative process between boards and shareholders, similar to what typically happens in legislative bodies.[194] Deliberation allows agents to convey their interpreted signals directly, to receive feedback from other participants, and to modify their signals in response to that feedback. The obvious alternative to collaboration is the aggregation of shareholder information through the capital markets.

It is widely recognized that the public capital markets collect and incorporate a wide variety of firm-specific and industry information, information that is incorporated through pricing.[195] Notably, Frederick Hayek was the first to emphasize how the dispersed individual knowledge aggregated through market contracting accurately determines prices, even if the average individual market participant cannot.[196] Under Hayek's epistemic version of Adam Smith's invisible hand,[197] the price system provides a form of mediated interaction between insiders and shareholders, which can be relied on to aggregate their respective information.[198] Moving from this assumption, Jeffrey Gordon's analysis of the independent board relies on the capital markets to convey shareholder information to independent directors.[199] Under this model, shareholder information, including shareholders' analysis of corporation decisions, is reflected by stock prices. Independent directors then use the information provided by prices for optimal

194. *See* John Gastil & James P. Dillard, *Increasing Political Sophistication Through Public Deliberation*, 16 POL. COMM. 3, 5 (1999) (discussing the effects of direct deliberation in influencing judgment).

195. The seminal treatment of the incorporation of information into market prices can be found in Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); *see also* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 565–89 (1984) (exploring the mechanisms by which information is incorporated into prices).

196. F. A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 526 (1945).

197. *See* Adrian Vermeule, *Many-Minds Arguments in Legal Theory*, 1 J. LEGAL ANALYSIS 1, 9–12 (2009) (examining how Hayek's "division of knowledge" idea, which emphasizes "the dispersed and tacit character of knowledge in markets," originated as an "aggregative invisible-hand mechanism[]").

198. One could argue that because this view relies on trading as a transmission mechanism, markets could aggregate shareholder information effectively but never fully aggregate insider information in a context in which insiders are prohibited by law from trading on their private information. This limitation, however, is overcome when one considers that insiders' disclosure obligations may also serve as a transmission mechanism, as both disclosure and trading serve to convey the agent's information.

199. Gordon, *supra* note 27, at 1470.

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decision-making, evaluating that information against their own private information about corporate affairs.

To the extent that prices provide a sufficient mechanism to aggregate relevant information, direct collaboration would thus seem to be unnecessary. We reject this conclusion and argue that the rise of shareholder collaboration responds to limitations in the ability of the capital markets to aggregate partial and complementary information. There are two sources of these limitations. First, there may be limitations to market efficiency.[200] Although over time, prices may converge to fundamental values, time delays and noise may result in persistent gaps between prices and fundamental values.[201] These gaps reduce the effectiveness of prices in informing business decisions. It follows that while prices can be useful for the *ex post* monitoring of corporate decisions, they are less useful for aggregating information on production decision-making.[202]

Second, asset-pricing theory teaches that information is aggregated only when traders have substitute information.[203] Here, substitute information is sufficiently similar information that a trader does not need other traders' information to make predictions about the value of a project or company. For example, one trader might have information on a company's sales, while another may have knowledge of a company's distribution agreements. Both sets of information provide a proxy on the company's future productivity, but neither prediction is substantially improved by access to the other trader's information.[204] As a result, each trader will trade based on her own information, which will then be incorporated in the company's stock price as predicted by the Hayekian model.

When traders have complementary information, the information of other traders enables each to make a more accurate prediction about the value of a project or company. Unlike substitute information, however, complementary information in competitive markets with partially informed traders may not get aggregated at all.[205] Consider, for example, the case of a computer manufacturer that is ready to launch a new computer. One investor

200. *See, e.g.*, Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 272 (2014) (observing that "market efficiency is a matter of degree").

201. For a more technical analysis of the sources of market inefficiency, see William W. Bratton & Simone M. Sepe, *Corporate Law and the Myth of Efficient Market Control*, CORNELL L. REV. (forthcoming 2020) (manuscript at 25–34).

202. *Id.* at 34.

203. Asset-pricing theory in this case talks of "non-separable" securities. *See* Michael Ostrovsky, *Information Aggregation in Dynamic Markets with Strategic Traders*, 80 ECONOMETRICA 2595, 2596 (2012) ("If the security is 'non-separable,' then there exists a prior and an equilibrium such that information does not get aggregated.").

204. In the actuality, information is never totally substitute or complementary but rather partially complementary and partially substitute. Therefore, the representation in the text above, as well as in the example in subpart III(B), should be intended as providing a stylized illustration of current informational structures.

205. Ostrovsky, *supra* note 203, at 2596.

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specializes in hardware products, while the other trader is an expert in software. In this case, the two sets of information are complementary because each investor could benefit from access to the other's information to make a better prediction about the compatibility of the new computer's hardware with the software available (or forthcoming) in the market. It follows that both investors will trade on incomplete information about the project's value, which will be reflected in an inaccurate evaluation of the project and, therefore, inaccurate pricing of the company's stock.

Unlike market trading, a deliberative process allows the investors to combine their complementary information about the new computer project to evaluate the project and transmit relevant knowledge to each other or the board or both. Accordingly, when different pieces of information are complementary such that the possession of one piece of information increases the value of acquiring another piece, only the direct communication of information allows corporate actors to extract that added value, while the mediated transmission of information through market trading cannot. Only through a deliberative process can investors convey their full information set, which may have multiple dimensions (meaning that one signal may be associated with multiple states of the world). In contrast, when investors communicate through trading, they can only observe market prices, which are unidimensional objects.

3. The Value of Collaboration: An Illustration.—We offer, in this section, a hypothetical example to illustrate in more detail the potential superiority of collaboration over market trading for aggregating the complementary information of corporate insiders and shareholders. For simplicity, the example focuses on the relationship between the board and a single investor, but the analysis can be extended to cases involving information possessed by multiple participants, including managers, independent boards, hedge funds, and institutional investors.

Consider a computer manufacturer, which we will call NewSys, that is about to launch a new computer. Similar to the stylized illustration at the end of section 2 above, we assume that the board of NewSys has private information on the hardware produced by NewSys, while RedRock, an investor, has private information on the software that is available on the market,[206] so that the two information sets are complementary.[207]

206. RedRock's information may come from its engagement with other portfolio companies or industry expertise that it has developed through research. The board may also have information on available market software but not the same information as RedRock.

207. For simplicity, the example represents the investors' partial information in terms of asymmetric information, meaning that both the board and the investors have private information not available to the other party. Conceptually, however, this need not be the case. For example, in the Microsoft case discussed above, ValueAct did not hold private information not available to the

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Assume that the value of NewSys critically depends on the success of the computer project, which turns on the compatibility of the new hardware with the available and emerging software, the standards for which are being developed in the industry. The uncertainty affecting the compatibility between the hardware and the software is captured by four possible states of the world, whose occurrence is equiprobable (i.e., each state materializes with a probability of one-fourth). These states are *A*, *B*, *C*, and *D* and have the following characteristics:

> Under State *A*, the hardware produced by NewSys is of Type 1, while a new operating system available from developers in the market is of the kind Compatible 1. This means that the developers' new software matches NewSys's hardware;
>
> under State *B*, the new hardware is of Type 1, while the new software is of the kind Compatible 2. This means that the available software does not match the new hardware;
>
> under State *C*, the new hardware is of Type 2, while the new software is of the kind Compatible 1. This means that the available software does not match the new hardware;
>
> under State *D*, the new hardware is of Type 2, while the new software is of the kind Compatible 2. This means that the available software matches the new hardware.

NewSys's computer project will be valuable if its hardware is compatible with the new software, as captured by States *A* and *D*, but not in States *B* and *C*. To capture this, assume that shares of NewSys stock have value equal to $200 under States *A* and *D* and zero under States *B* and *C*.

Further assume that under the above informational structure, where the board has private information on the hardware and RedRock has private information on the available software, each receives a signal based on its private information. The board's received signal can be either a_1 or a_2. If the signal is a_1, the board knows that the new computer is of Type 1; therefore, the state of the world will be either *A* or *B* with the same probability. If the signal is a_2, the board knows that the new computer is of Type 2; therefore, the state of the world will be either *C* or *D* with the same probability. Similarly, RedRock receives a signal that can be either r_1 or r_2. If the signal is r_1, RedRock knows that the software is of the kind Compatible 1; therefore, the state of the world will be either *A* or *C* with the same probability. If the signal is r_2, RedRock knows that the software is of the kind Compatible 2;

Microsoft board but rather proposed a different interpretation of information shared by the board. *See supra* text accompanying notes 114–23. This said, from a modeling perspective, a different interpretation of the same information can be represented, in a first approximation, as novel information and hence as a matter of asymmetric information. Therefore, the use of an asymmetric information setting in our example imports no loss of generality.

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therefore, the state of the world will be either *B* or *D* with the same probability.

Under this information structure, both the board and RedRock expect the value of the computer project as reflected in the price of NewSys stock to be $100.[208] If the board receives the signal a_1, the state of the world can be either *A* or *B* with the same probability, making the expected value of NewSys stock ½ × ($200) + ½ × (0) = $100. The same holds if the board receives the signal a_2 (under which the state of the world can be either *C* or *D* with the same probability). Likewise, if RedRock receives the signal r_1 (under which the state of the world can be either *A* or *C* with the same probability), the expected value of NewSys stock to RedRock is also $100. The same holds if RedRock receives the signal r_2 (under which the state of the world can be either *B* or *D* with the same probability).

Competitive trading in this case will not aggregate the complementary information of the board and RedRock, as each party is unable to infer anything from the other party's valuation of the NewSys stock. Under the price signal reflecting RedRock's beliefs, the board will not be able to update its beliefs about the compatibility of the computer project with the software market. This simple illustration then shows that competitive trading does not allow market participants to coordinate information to make value-maximizing operational decisions. Indeed, in this scenario, the board will underinvest relative to a scenario in which it knows about the project's compatibility with the software and hence that the true value of the project to NewSys is $200. Correspondingly, the board will overinvest relative to a scenario in which it can determine that the project is flawed due to an absence of compatibility.

Consider now a scenario where the board and RedRock can directly communicate with each other. For example, suppose the board receives the signal a_1 (under which the true state of the world is either State *A* or *B*) and RedRock receives the signal r_2 (under which the true state of the world is either State *B* or *D*) and they exchange this information. Through this deliberation, the board and RedRock will learn that the only state that is consistent with their respective signals is State *B*. That is, they would both know that computer is of Type 1, while the software is of the kind Compatible 2, which implies that the computer project has no value. This would enable the board to make a better operational decision by halting the hardware investment. On the other hand, under reciprocal signals that are

208. Defining NewSys stock as *S*, this result is calculated as follows: $S|a_1 = S|a_2 = S|r_1 = S|r_2 = 100$. More analytically, $S|b_1 = [Prob\ (A)|a_1] \times ($200) + [Prob\ (B)|a_1] \times (0) = 100, where, by Bayes's Rule, $Prob\ (A)|a_1 = [Prob\ (a_1|A) \times Prob\ (A)]/[Prob\ (a)] = (½ \times ¼)/(½) = ½$ as $Prob\ (a_1) = Prob\ (A) + Prob\ (B) = ½$. In this example $Prob\ (B)|b_1$, $Prob\ (C)|b_2$, $Prob\ (D)|b_2$, $Prob\ (A)|r_1$, $Prob\ (C)|r_1$, $Prob\ (B)|r_2$, and $Prob\ (D)|r_2$ are each equal to ½. Because $S|a_2 = S|r_1 = S|r_2$ are also computed following the same procedure, it is clear why both the board and RedRock expect NewSys stock to be equal to $100.

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compatible with a matched technology (i.e., State *A* or *D*), the board would know that it is desirable to expand the investment in the computer project. Therefore, aggregating the board's complementary information with that of investor RedRock would enable NewSys to match its operational decision-making to the state of the outside world in a way that maximizes firm value (and stock price).[209]

B. The Governance of Collaboration

The preceding discussion has shown that collaboration is socially efficient, as it can contribute value that neither unilateral decision-making nor the mediated transmission of information through markets can provide. We now turn to the governance of collaboration, drawing on insights from the theory of cooperative games to identify what governance structures can help ensure that both corporate insiders and investors have the right individual incentives to collaborate.[210]

1. Economic Rights.—In the language of game theory, shareholder collaboration can be understood as a "cooperative" game. A game is defined as cooperative when players form "coalitions" to achieve their mutual goals.[211] Two preliminary conditions determine whether it is worthwhile for

209. For completeness, we also consider the case in which information is substitute rather than complementary. In this case, assume that RedRock receives an unambiguous signal that the true state is *A*, so that Prob (A)$|r_1 = 1$ holds. Also assume that the board still receives the original signal a_1, so that Prob (A)$|a = ½$. Since RedRock has perfect information on the true state, while the board only has partial information, RedRock does not need to aggregate the board's information to improve its predictions. Under these different circumstances, upon the occurrence of State *A* and after receiving its informative signal, RedRock will be willing to buy more NewSys stock, as it knows that NewSys's fundamental value is $200, and RedRock's trading will drive up the share price. RedRock will be willing to buy NewSys shares as long as the price is below $200. Upon observing RedRock's trading, the board will in turn realize that the only state that is compatible with its private information (under which the true state can be either *A* or *B*) and with a trading price above $100 is State *A*. This is consistent with the conclusion that when information is substitute, market trading efficiently aggregates information. Note, however, that this aggregation does not solve other asset-pricing imperfections such as timing issues. Indeed, sophisticated investors with short-term business models may have distortionary incentives, including incentives not to reveal their information immediately. These distortions increase when investors have market power. *See* Giovanni Cespa & Xavier Vives, *Dynamic Trading and Asset Prices: Keynes vs. Hayek*, 79 REV. ECON. STUD. 539, 540 (2012) (formally showing that in a dynamic market, rational investors can find it profitable to speculate on short-term price differentials).

210. It is worth observing that one can describe most strategic interactions as employing either cooperative or noncooperative game theory. *See* MARTIN J. OSBORNE & ARIEL RUBINSTEIN, A COURSE IN GAME THEORY 255–56 (1994) (explaining the differences between cooperative and noncooperative approaches when used to represent individual strategic decisions in a coalition). In the latter case, the model becomes one of bargaining with alternative offers. However, while one could argue that the analytical result would be the same, we believe that cooperative game theory is better suited to represent the novel collaborative dynamics between corporate insiders and outside investors.

211. A cooperative solution involves a stable set of outcomes such that it meets two conditions:

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the players to form a coalition. First, the players must be able to do better together than alone—this is the *superadditivity* condition.[212] Second, larger coalitions must be more valuable than smaller ones—this is the *monotonicity* condition.[213]

Insider–shareholder collaboration satisfies both conditions. First, as detailed in the preceding subparts, participatory deliberative mechanisms allow the corporation to capture the added value of insider and shareholder complementary inputs. Assuming that both insiders and shareholders receive a portion of this added value, collaboration thus satisfies superadditivity. Second, the value added by collaboration naturally increases with the number of investors participating in the deliberative process so long as information is complementary. As a result, larger coalitions will outperform smaller coalitions and therefore satisfy monotonicity.[214]

The theory of cooperative games also teaches that a coalition must be beneficial for each individual player. That is, a player's incentive to participate requires that a player's expected gains from participation exceed what the player would receive by playing individually outside the coalition.[215] As applied to shareholder collaboration, this implies that the participation costs involved by collaboration must be reflected in the expected payoff. For example, collaborating shareholders may incur significant research costs[216] that they will be unwilling to bear unless the share of the gains from collaboration compensates them for such costs.

This constraint raises questions about the appropriate allocation of *economic rights*—how the value produced by the coalition should be divided among its members. In the corporate context, the existing allocation of economic rights contains two components, which, we argue, are by their nature compatible with insider–shareholder collaboration. The first is the equity contract, which allocates gains from the corporation in a manner that is proportionate to investors' economic interests. The second is equity-based compensation for corporate insiders—officers and directors.

"(1) for every outcome outside the [cooperative] set some coalition can achieve an outcome inside the set that is better for all its members and (2) no coalition can achieve an outcome inside the set better for all its members than another outcome inside the set." PAUL WEIRICH, COLLECTIVE RATIONALITY 152 (2010).

212. MICHAEL MASCHLER ET AL., GAME THEORY 671 (Mike Borns ed., Ziv Hellman trans., 2013).

213. *Id.* at 672.

214. Notably, the shift to reconcentrated equity ownership both enables the implementation of participatory deliberative mechanisms and limits the number of investors who possess the incentives and resources to collaborate with insiders.

215. WEIRICH, *supra* note 211, at 156.

216. Under the assumption that proxy-fight costs are, at least in part, indicative of an investor's research costs, it is worth observing that a campaign ending in a proxy fight has an average cost for the investor of around $10.71 million. Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 611 (2013).

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The pro-rata rule embedded in the equity contract is the distinctive feature that makes this contract compatible with shareholder collaboration, thus supporting the view that collaboration is consistent with the existing structure of corporate law. Indeed, the pro-rata rule facilitates efficient collaboration in several ways. First, by ensuring that shareholders participate in the value added proportionately to the size of their equity stake, pro-rata sharing makes it rational for shareholders to engage in the production of complementary information and make a substantial investment prior to collaborating.[217]

Second, by ensuring that investors internalize both the benefits and the costs of engagement, the pro-rata rule anchoring investors' payoff from collaboration to the size of their equity stakes increases the likelihood that collaborative efforts will be designed to enhance firm value.

Third, the equity contract also reduces (but does not eliminate, as we note below) the concern that collaboration might be a vehicle through which players collude to obtain private benefits. Such concern, for example, undermines the viability of collaboration in the administrative context, where critics worry that collaborative processes might be exploited by powerful industry players and public interest groups to the detriment of the general public interest.[218] In the corporate context, this risk is reduced because the equity contract provides a premium to *all* shareholders from efficient collaboration (proportionally to their equity stake), leveling the bargaining power of all interested parties in the distribution of the gains arising from deliberation.

Equity-based compensation contracts, which tie executive compensation to equity returns, further ensure the compatibility of collaboration with the existing structure of corporate law by giving executives their own incentives to participate in value-increasing collaboration. Indeed, executive-compensation structures have evolved over the past thirty years to feature both an increasing proportion of equity-based compensation[219] and compensation structures that involve longer time horizons for the realization of increases in stock price.[220] Outside directors also receive a substantial proportion of their compensation in the form of

217. Empirical evidence suggests that hedge fund activists, for example, typically acquire substantial stakes in target companies before publicly announcing their presence, allowing them to benefit if their activism increases firm value. *E.g.*, Lucian A. Bebchuk et al., *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. CORP. L. 1, 9–10 (2013).

218. Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1, 83 (1997).

219. Kahan & Rock, *supra* note 26, at 884.

220. *See, e.g.*, Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1925–26 (2010) (describing issuer adoption of compensation plans that require executives to hold stock until retirement).

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equity such as stock options and restricted stock rather than cash.[221] By aligning the interests of insiders with those of shareholders, these compensation structures also create an incentive for both to exploit collaboration to maximize firm value. In addition, compensation structures that involve longer time horizons encourage insiders to collaborate to produce long-term value for the firm.

2. Decision-Making Rights.—In addition to economic rights, a coalition also involves *decision rights*—bargained-for rules that the coalition's members accept to regulate their individual say in the deliberative process. In the corporate context, efficient collaboration involves questions on the optimal allocation of decision-making power between the board and the engaged shareholders and the relative say of each shareholder.

Given the positive implications of the equity contract for managing collaboration's economic rights, one might think that the "one share, one vote" rule embedded in that contract should naturally apply to the decision rights of the collaborative process. We question this conclusion primarily on the basis that shareholders with similar equity stakes may not be equally positioned to produce valuable firm-specific information. For example, a hedge fund that has a private-equity-like investment policy and only invests in a restricted portfolio of companies (as is the case of ValueAct, for example)[222] might be better positioned to produce complementary information than a hedge fund of similar size with a larger portfolio of companies or a larger but highly diversified index fund (as in the case of Vanguard, for example).

Insights from game theory are again useful here. In cooperative games, gains are distributed according to each player's marginal contribution to the game's outcome, that is, the incremental value added by that player joining the game.[223] Consistent with this approach, we suggest that a party's say over the collaborative process should be determined according to the marginal contribution of that party's informational inputs. The marginal contribution criterion is suited to capture the "specificity" of an informational investment in a corporation—as under this criterion, specific information that belongs exclusively to one investor is valued more than information that is shared by more investors. Put differently, the marginal contribution criterion is well suited to reflect the value of the sunk costs made by an investor in a given

221. *See, e.g.*, Nitzan Shilon, *Putting Directors' Money Where Their Mouths Are: A New Approach to Improving Corporate Takeover Dynamics*, 2017 COLUM. BUS. L. REV. 511, 536 & n.57 (observing that "director pay increasingly includes stock" and restricted stock).

222. WALKER, *supra* note 77, at 17.

223. This is referred to as the "Shapley value" criterion. MASCHLER ET AL., *supra* note 212, at 760–61. More technically, in a cooperative game, the possible efficient joint acts (here, the different coalitions of the board and the investors) are distinguished by the order in which the players may form a coalition of all players. *See id.* The Shapley value then accords each player the average of her marginal contributions to the possible efficient joint acts. *See id.*

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corporation, costs that may not be directly proportional to the size of the investor's equity stake.[224]

In practice, the contribution criterion will frequently presume that the board of directors is the "player" with the highest marginal contribution, as it is the decision-maker that consistently provides the most specific informational inputs about firm operations. The jargon of game theorists would therefore term the board the "veto player," without which the coalition cannot be formed in the first place.[225] As a *positive* matter, this presumption is consistent with the substantial authority corporate law grants to the board of directors in managing the corporate affairs.[226] The access of directors (especially executive directors), as insiders, to unique, firm-specific private information also *normatively* supports this presumption. Indeed, the need to aggregate the partial, complementary information of insiders and shareholders does not displace standard asymmetric information issues but rather stands on top of such issues. Making the board the game's veto player thus addresses the twin problem of partial and asymmetric information.[227]

The presumption that the board is the player with the highest marginal contribution should not be absolute, however. Rather, this presumption should be regarded as weaker in situations in which the firm is underperforming. This underperformance signals that investors may be more likely to add potential value through the production of complementary information. Here the collaborative-activist strategy of presenting the board and, if need be, its fellow shareholders, with a detailed plan documenting its research into the company provides the connection between the activist's informational contribution and vesting the activist with an enhanced deliberative role.[228] The mechanism for providing an activist with decision-making power is the grant of board seats. The success of the activist in obtaining board representation depends on the quality of the information that

224. We do not propose to use the marginal contribution criterion for economic rights because it would create incentives for investors to overstate their contributions (that is, the value of their complementary information).

225. *See* MASCHLER ET AL., *supra* note 212, at 681 (demonstrating mathematically the power of a veto player to scuttle any coalitions it does not support).

226. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2011); MODEL BUS. CORP. ACT § 8.01(b) (AM. BAR ASS'N 2016).

227. Note, however, the difference from the managerial-power model's characterization of the board's informational advantage. Under that model, the board's access to private information about the corporate affairs serves to exclude shareholder informational inputs. Under the collaborative model, the board's position as veto player is instrumental to collaboration and hence to the inclusion, rather than the exclusion, of shareholder inputs.

228. Even skeptics of shareholder activism recognize that credible activists typically approach the issue with an extensive, well-researched proposal for change. *See, e.g.*, Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 26, 2017), https://corpgov.law.harvard.edu/2017/01/26/dealing-with-activist-hedge-funds-and-other-activist-investors/ [https://perma.cc/TB39-M6CL] (observing that "[t]he activist may approach a company with an extensive high-quality analysis of the company's business that supports the activist's recommendations").

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it presents. Moreover, both the board and other shareholders play a valuable role in vetting the activist's contribution because the activist is only in a position to obtain board representation if it comes forward with a credible plan that is likely to receive the support of the other shareholders.

From this perspective, the marginal contribution criterion helps reconceptualize settlements in which a board voluntarily appoints investors' representatives in a constructive context as a reflection of a high informational contribution on the investors' part. For example, in the Microsoft case discussed above,[229] the appointment of a ValueAct representative to the board reveals the importance that ValueAct's "perception problem" approach had for reforming Microsoft's business. More generally, the marginal-contribution criterion provides a basis for structuring the form of shareholder collaboration and choosing between the broad spectrum of available collaborative schemes. For example, higher marginal contributions are more likely to be reflected in greater decision rights such as through board representation. Conversely, relatively low contributions are more likely to be organized in the form of "non-binding outside" deliberation, such as informal meetings.

IV. The Challenges of the Collaborative Model

The discussion in Part III demonstrates how collaboration can increase firm value and identifies the conditions necessary for collaboration to be effective when both shareholders and insiders act unselfishly. Under this assumption, collaboration is not just socially efficient but also individually efficient for both insiders and collaborating investors. In the real world, however, things can go wrong. Specifically, insiders and collaborating shareholders may act opportunistically and either jeopardize the viability of value-increasing collaboration or exploit collaboration to further their own interest at the expense of overall firm value. Existing principles of corporate law, which operate largely from the premise of insider–shareholder confrontation, emphasize these risks.

In this Part, we identify three basic categories of risks. First, there is the risk that shareholders and insiders will each engage in detrimental opportunistic behaviors, exacerbating a firm's conflicts of interest at the expense of firm value. Second, shareholders that gain access to firm-specific information as a result of the collaborative process may misuse that information to benefit themselves or to harm the corporation. Third, there is the risk of insider–shareholder collusion that may sacrifice the interests of other shareholders or nonshareholder constituencies. Corporate law currently employs tools such as fiduciary duties and confidentiality agreements to

229. *See supra* notes 114–23 and accompanying text.

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address these concerns, but the tools are ill-suited for a collaborative context and should be rethought.

A. Conflicts of Interest

1. Transparency, Accountability, and Opportunism.—Collaboration increases concerns about conflicts of interest in several ways. First, collaboration may reduce the transparency of firm decision-making. Second, collaboration may limit the accountability of corporate decision-makers. Third, collaborating shareholders may exploit their influence over corporate affairs opportunistically, pursuing objectives with respect to firm value that differ from those of other shareholders.

The recent increase in negotiated settlements that provide activists with board representation is an example of both reduced transparency and accountability. As discussed above,[230] insiders are increasingly voluntarily appointing one or more activist-designed directors to the board to settle an activist campaign. In many cases, the settlement occurs rapidly, before outside shareholders have taken a position on the activist's agenda, and in some cases, even before the activist's role has become public. The selection of the new directors is a matter of negotiation between the insiders and the activist, displacing the role of outside shareholders in the election process.[231] The terms of the settlement may also limit the ability of the new directors to criticize corporate policy or to vote against board proposals.[232] For these reasons, a number of investors have begun to raise objections to these settlements.[233]

Whether or not they obtain board representation, shareholders may exploit their influence for opportunistic reasons. The most commonly cited risk of shareholder opportunism is short-termism.[234] Some investors, for

230. *See supra* text accompanying notes 100–03.

231. *See* Rakhi Kumar & Ron O'Hanley, *Protecting the Interests of Long-Term Shareholders in Activist Engagements*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 17, 2016), https://corpgov.law.harvard.edu/2016/10/17/protecting-the-interests-of-long-term-shareholders-in-activist-engagements/ [https://perma.cc/8GCG-E68S] (expressing concern that "in some cases these settlements are being reached too quickly and without any input from other shareholders").

232. Che Odom, *Companies Using Deals with Activists to Protect Directors*, BLOOMBERG BNA (June 15, 2016), https://web.archive.org/web/20160616052445/https://www.bna.com/companies-using-deals-n57982074192/ [https://perma.cc/BB7V-KNAF?type=image].

233. *See, e.g.*, Kai Haakon Liekefett & Lawrence Elbaum, *Think Twice Before Settling with an Activist*, LAW360 (Dec. 9, 2016, 12:21 PM), https://www.law360.com/articles/869160/think-twice-before-settling-with-an-activist [https://perma.cc/NB74-4RRF] (observing that institutional investors "are now troubled that companies may settle with activists without seeking the input of other shareholders"); *see also* Coffee, *supra* note 99, at 25 (charging that these settlement agreements disenfranchise other shareholders that may not support the activist's nominees).

234. Short-termism can be understood, we argue, as a form of shareholder self-dealing that produces a conflict between the interests of the short-term shareholders and shareholders generally.

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example, hedge funds with short-term-oriented business models, may benefit from short-term operational strategies that sacrifice long-term firm value.[235] A number of commentators have argued that "the short-term strategies of many activists are frequently at odds" with the investment horizon of other shareholders.[236] Delaware Supreme Court Justice Leo Strine, for example, has contended that, although some activist hedge funds are committed to long-term improvement of their portfolio companies, others pursue business strategies calculated to produce a short-term price "pop," at which point they exit, leaving "buy and hold investors" to bear the consequences.[237]

But shareholders may also have other conflicts that collaboration may exacerbate. A shareholder may seek to influence a decision at one portfolio company to improve the value of its position at another company.[238] Or shareholders may have what Marcel Kahan and Edward Rock have termed "hedging-related conflicts" when they hold positions in different types or

See K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67, 114–16 (2016) (describing this conflict).

235. *See, e.g.*, *In re* PLX Tech. Inc. Stockholders Litig., No. 9880-VCL, 2015 WL 13501398 (Del. Ch. Sept. 3, 2015) (order granting in part defendants' motion to dismiss) (citing the concern that "particular types of investors may espouse short-term investment strategies and structure their affairs to benefit economically from those strategies"); Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 790–91 (2015) (arguing that activist shareholder "pressure may logically lead to strategies that sacrifice long-term performance for short-term shareholder wealth"); Liekefett & Elbaum, *supra* note 232 (stating that activists "focus on short-term, event-driven strategies"). Shareholder strategies that are often criticized as short-term include investment banking interventions like agitating for a sale of the company, causing the issuer to pay out higher cash dividends or take on additional debt, and efforts to cut costs, including research and development. Francis Byrd et al., *Short-Term Shareholder Activists*, HEDGE FUND J. (July 2007), https://thehedgefundjournal.com/short-term-shareholder-activists/ [https://perma.cc/867J-YE9H].

236. Liekefett & Elbaum, *supra* note 233.

237. Strine, *supra* note 42, at 1908, 1928.

238. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1071 (2007) (noting that "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"). A well-known example involves Perry Corp.'s acquisition of additional voting rights in Mylan Pharmaceuticals in an effort to sway the shareholder vote necessary to approve Mylan's acquisition of King Pharmaceuticals. Perry held a substantial interest in King, and King shareholders stood to obtain a 61% premium if the merger went through, but the deal required the approval by Mylan's shareholders and did not appear to be value-enhancing for Mylan. Perry therefore hoped to use its voting power in Mylan to push through a merger that was not value-enhancing for the company. Several commentators have discussed the Mylan–King merger and Perry's conflict of interest. *E.g.*, Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 828–29 (2006); Kahan & Rock, *supra* note 237, at 1075–76; Steven M. Haas, *SEC Resolves Empty Voting Action Involving King-Mylan Merger*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 19, 2009), https://corpgov.law.harvard.edu/2009/08/19/sec-resolves-empty-voting-action-involving-king-mylan-merger/ [https://perma.cc/M55T-GF8B].

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classes of securities[239] or when they hold both long and short positions.[240] More generally, collaboration creates a risk that collaborating shareholders will use their engagement to further their objectives—financial, political, or social—in ways that favor their personal interests and do not align with the interests of their fellow shareholders.[241] For example, some commentators have criticized large mutual funds for advocating sustainability objectives.[242]

2. Fiduciary Obligations.—The risks raised by shareholders' conflict of interests have also led to concerns about the *conduct* of activist representatives who serve on the board of directors. Activist directors raise unique fiduciary issues because they are called to serve both the corporation (that is, the shareholders at large) and their nominating sponsor.[243] As noted above, the interests of the activist may differ from those of the corporation or the other shareholders.[244] Although a shareholder has the legal right to act out of self-interest,[245] once an activist nominee joins the board, it may not further that shareholder's interests over those of other shareholders.[246] This has led some commentators to observe that "the concept of activist representatives as board members is fraught with potential for conflict."[247]

Similar issues have arisen in the VC context in relation to the appointment of constituency directors, who may be held liable for breaching their fiduciary duty by favoring the interests of one set of shareholders over

239. An analogous phenomenon occurs in the bankruptcy context because hedge funds, which have often purchased deeply discounted debt securities, have interests that differ both from other creditors and from shareholders. *See* Bo J. Howell, *Hedge Funds: A New Dimension in Chapter 11 Bankruptcy Proceedings*, 7 DEPAUL BUS. & COM. L.J. 35, 46 (2008) (observing how such conflicts can create problems when hedge funds serve on a creditors' committee).

240. Kahan & Rock, *supra* note 237, at 1072–74. Kahan and Rock describe an example involving the planned acquisition of MONY by AXA in 2004. *Id.* at 1073–74; *see also In re* MONY Grp., Inc. S'holder Litig., 853 A.2d 661, 668 (Del. Ch. 2004) (describing hedge fund conflicts).

241. *See, e.g.*, Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1286 (2008) (describing efforts by CalPERS to use its influence as a shareholder to further the union interests in a battle with Safeway over worker benefits).

242. In 2018 guidance, for example, the Department of Labor warned that "the Department has rejected a construction of ERISA that would render ERISA's tight limits on the use of plan assets illusory and that would permit plan fiduciaries to expend trust assets to promote myriad public policy preferences." U.S. DEP'T OF LABOR, FIELD ASSISTANCE BULLETIN NO. 2018-01 (2018) (alterations omitted) (quoting Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 81 Fed. Reg. 95879, 95881 (Dec. 29, 2016)).

243. E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761, 774 (2008).

244. *See* Sepe, *supra* note 58, at 341–60 (providing a detailed law and economics discussion of the matter).

245. *See* Anabtawi & Stout, *supra* note 241, at 1273 (noting shareholders typically do not owe a fiduciary duty to the corporation).

246. *See, e.g.*, Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 240 (2009) (describing the fiduciary concept in the corporation).

247. Liekefett & Elbaum, *supra* note 233.

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another.[248] Corporate law has struggled with the tension between this divergence of interest and classic fiduciary principles, a struggle illustrated by the *Trados*[249] decision, in which the Delaware Chancery Court noted that constituency directors who favor the interests of preferred stockholders over those of common stockholders may breach their fiduciary duties.[250]

Trados illustrates the limits of fiduciary duties in dealing with horizontal conflicts among shareholders. One of us has argued that the principle of party autonomy should operate as a limiting principle to the application of fiduciary duties, and a constituency director should not be viewed as conflicted merely because he or she is acting in the interests of that party.[251] Shareholder collaboration increases the potential for horizontal conflicts and requires corporate law to take a more expansive view of mechanisms designed to allocate shared control without subjecting those mechanisms to the pervasive limits of conventional fiduciary principles.[252]

The concern about conflicts is not limited to constituency directors. When shareholders collaborate with corporate insiders, they are acting simultaneously for their private benefit and for the benefit of the corporation in a manner that is designed to influence corporate decisions. The potential for conflicts has led some commentators to call for a broader scope of fiduciary duties when shareholders collaborate with insiders. Iman Anatwabi and Lynn Stout, for example, argued that activist hedge funds' increasing control over operational decisions should cause us to reconsider corporate law's current restrictive approach to shareholders' fiduciary obligations. Indeed, they argued, a shareholder should owe fiduciary duties whenever it "manages to successfully influence the company's actions with regard to a particular issue in which that shareholder has a material, personal economic interest."[253]

This approach is both too broad and too restrictive. Collaboration does not and should not convert shareholders into fiduciaries, thereby imposing upon them the burden of demonstrating that, when they attempt to influence corporate decisions, their actions conform to the strict obligations of

248. For an illustration of the potential divergence between the interests of shareholders and creditors and its implications for corporate decision-making, see Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *33–34 (Del. Ch. Dec. 30, 1991).

249. *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958 (Del. Ch. July 24, 2009).

250. *Id.* at *7.

251. Sepe, *supra* note 58, at 377–78.

252. We note that the Delaware legislature endorsed this approach in the context of the corporate opportunity doctrine. *See* Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1077–79 (2017) (empirically analyzing the Delaware statutory amendment enabling corporations to opt out of the corporate opportunity doctrine by contract).

253. Anabtawi & Stout, *supra* note 241, at 1295. Notably, the authors focus their proposal primarily on activist hedge funds.

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disinterestedness and unselfishness.[254] Allowing shareholders to pursue their personal interests is a fundamental component of corporate law, and it is a critical component of the incentive structure for effective collaboration. Indeed, the legal requirement of selflessness associated with the role as a fiduciary would chill all types of shareholder engagement and, as a result, defang the enhanced involvement of shareholders that has transformed corporations from the time of Berle and Means.

Moreover, premising fiduciary obligations on a shareholder's ability to influence corporate decisions is impractical. Shareholders can influence firm decision-making through a range of mechanisms, from the introduction of shareholder proposals to participation in corporate governance organizations. Even a small shareholder's actions may be outcome determinative. In the Proctor & Gamble proxy contest, for example, the margin of victory was approximately 42,000 votes (out of a total of nearly two billion).[255] Accordingly, the vote of any shareholder that voted more than 42,000 shares was, by definition, outcome determinative, and under a broad definition of fiduciary such as that proposed by Anabtawi and Stout, such a shareholder would be held to a duty-of-loyalty standard in defending its voting decision.

3. Insiders' Conflicts.—Insiders present different types of conflicts. The most obvious is management entrenchment. Corporate insiders may make value-decreasing decisions that allow them to preserve private benefits, including empire-building, large compensation packages, perks, and the power and prestige of their positions. Although management entrenchment is not a concern specific to the collaborative model of the corporation, shareholder collaboration presents distinctive considerations. First, although shareholder engagement has the potential to reduce entrenchment, the risk remains that entrenched management might be systematically nonresponsive and noncollaborative. This is because refusing to collaborate is rational for management if it allows firm insiders to preserve private benefits that they could lose in a deliberative process.[256]

254. The Department of Labor's effort to impose fiduciary obligations on brokers when they provide investment advice in connection with a retirement plan raises similar issues about the feasibility of subjecting a market participant acting out of financial motives to a legal requirement to act selflessly. *See* Chamber of Commerce v. U.S. Dep't of Labor, 885 F.3d 360, 366, 388 (5th Cir. 2018) (invalidating DOL fiduciary rule). As one commentator observes: "By nature, any compensation places the interests of the adviser in conflict with those of the client." Blaine F. Aikin, *Mitigating Conflicts of Interest in Compensation*, INV. NEWS (Oct. 25, 2017, 4:19 PM), http://investmentnews.com/article/20171025/FREE/171025/FREE/171029963/mitigating-conflicts-of-interest-in-compensation [https://perma.cc/QUW7-HU3G].

255. Sharon Terlep & David Benoit, *P&G Concedes Proxy Fight, Adds Nelson Peltz to Its Board*, WALL ST. J. (Dec. 15, 2017, 7:18 PM), https://www.wsj.com/articles/p-g-concedes-proxy-fight-adds-nelson-peltz-to-its-board-1513377485 [https://perma.cc/52GP-6M4P].

256. This raises the question of whether officers and directors have a fiduciary duty to collaborate with shareholders and whether their refusal to do so could, under some circumstances, be actionable.

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Second, there is also the risk that some collaborating investors may increase managerial moral hazard by reducing their monitoring or otherwise acquiescing in insider private gains in exchange for concessions. Those concessions might, in the case of a mutual fund, be governance reforms such as board refreshment. In the case of an activist hedge fund, the concessions might be the payment of a cash dividend. Such concessions could be low cost for the insiders, cosmetic, or favor a hedge fund's short-term interests, but the point is both that they relieve insiders from the pressure of investor oversight and that they are likely to take the form of negotiated settlements that are neither transparent nor approved by all shareholders.

B. Misuse of Information

Effective collaboration also requires that, in some cases, corporate insiders share firm-specific information with investors. This information sharing can take various forms. Corporate insiders who meet privately with investors may provide those investors with nonpublic information during those discussions. Shareholders that gain access to corporate insiders, such as by identifying representatives to serve as directors or board observers, are also likely to receive nonpublic information about the corporation, its operations, and business strategy on an ongoing basis.

Perhaps the most obvious concern raised by information sharing is that shareholders may use the information to obtain a trading advantage. A variety of empirical studies report that shareholders who meet privately with insiders obtain trading advantages.[257] Although these studies focus primarily on interactions that are oriented toward informing trading decisions, such as meetings with research analysts, shareholder use of information access for the purpose of trading is a serious concern. In addition, a recent article analyzes the specific context of the appointment of activist nominees to a company's board of directors and finds that such appointments are associated with information leakage into stock prices.[258]

The federal securities laws address the misuse of firm-specific information in two ways. First, insiders who disclose information to shareholders in circumstances in which that information is likely to be used in securities trading violate Regulation Fair Disclosure (Regulation FD).[259] Regulation FD makes it unlawful for corporations and their agents to provide

257. *E.g.*, Jihwon Park & Eugene Soltes, What Do Investors Ask Managers Privately? 7 (Dec. 2017) (unpublished manuscript), http://www.shareholderforum.com/access/Library/20171206_Park&Soltes.pdf [https://perma.cc/JMM8-H33D] ("A body of prior academic literature finds that investors who gain access to managers privately make more informed trades.").

258. John C. Coffee, Jr. et al., *Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board?*, 104 CORNELL L. REV. 381, 422 (2019); *see also* Coffee, *supra* note 99, at 17 (identifying similar concerns).

259. 17 C.F.R. § 243.100 (2018).

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certain kinds of selective disclosure to shareholders.[260] Second, federal law may impose insider trading liability upon both insiders who tip material nonpublic information to shareholders and the shareholders that trade on that information.

The disclosure of nonpublic corporate information raises concerns beyond securities trading, however.[261] Shareholders may misuse information in other ways.[262] Shareholders may, for example, use that information selfishly to gain an advantage for a competing portfolio company. A shareholder may also simply be careless or sloppy with the information in a way that harms the interests of the company. One highly publicized example of information misuse that was not linked to trading involved Bill Ackman, then a director of J.C. Penney, leaking confidential board information to the press.[263]

These concerns have led to a reluctance by the boards of some companies to share information with shareholders. A company may go so far as to adopt a policy under which insiders do not meet privately with investors. Sturm Ruger cited such a confidentiality policy, for example, as the basis for refusing to meet with large shareholders who were concerned about its firearms-manufacturing policies.[264] Ruger's confidentiality policy states that it is expressly motivated, in part, by the need to comply with Regulation FD.[265]

Of course, shareholders need not meet privately with insiders to collaborate. Shareholders can communicate their information or objectives to companies through letters, emails, or public statements, but these efforts are likely to be less effective at persuading insiders to reconsider their

260. *Id.*

261. Shareholders may also use information to obtain a trading advantage in another of their portfolio companies.

262. One paper, for example, finds evidence that hedge funds anticipate analyst reports with high information content and posits that the explanation for this finding is that hedge funds "strategically disclose their private information to sell-side analysts . . . in order to speed the incorporation of private information into stock prices." Nathan Swem, *Information in Financial Markets: Who Gets It First?* 24 (Bd. of Governors of the Fed. Reserve Sys. Fin. & Econ. Discussion Series, Working Paper No. 023, 2017), https://ssrn.com/abstract=2939519 [https://perma.cc/Z8C2-APT4].

263. Priya Cherian Huskins, *Boardroom Confidential: Directors and Their Duty*, WOODRUFF, SAWYER & CO. (Sept. 13, 2016), https://wsandco.com/do-notebook/boardroom-confidential/ [https://perma.cc/F2P5-MRZE].

264. *Sturm, Ruger & Co. (RGR) Q1 2018 Results - Earnings Call Transcript*, SEEKING ALPHA (May 9, 2018, 6:43 PM), https://seekingalpha.com/article/4171931-sturm-ruger-and-co-rgr-q1-2018-results-earnings-call-transcript?part=single [https://perma.cc/3GTC-KCKD] ("We don't do – we don't go meet with the big institutional shareholders, we don't hold meetings with our largest institutional shareholders like BlackRock or Vanguard." (quoting CEO Christopher John Killoy)).

265. RUGER, INVESTMENT COMMUNITY COMMUNICATIONS POLICY 2019, at 1 (2019), https://ruger.com/corporate/PDF/InvestorCommunicationPolicy.pdf [https://perma.cc/3BZX-A2XN].

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positions.[266] Moreover, the refusal of corporate insiders to meet privately with shareholders prevents the deliberation that distinguishes shareholder collaboration from other methods of communication.

Even when insiders meet privately with shareholders, however, they need not share material nonpublic information. The SEC guidelines explicitly state that Regulation FD does not prevent insiders from engaging privately with shareholders and offers procedural suggestions designed to prevent the accidental disclosure of nonpublic information such as preapproving topics for meeting and ensuring the presence of legal counsel.[267] For some investors, such as mutual funds, meetings that do not involve the dissemination of nonpublic information by corporate officials are likely to be optimal for both companies and investors because they both protect companies from potential securities liability and ensure that investors do not give up their ability to trade. Indeed, even without disclosing nonpublic information, private meetings enable insiders to probe investor preferences, explore the reasons for their positions, as well as provide investors with reasons why their preferences may not be consistent with the company's best interests.

The situation may differ for hedge funds. Like mutual funds, some hedge funds may prefer to avoid obtaining material nonpublic information to preserve their ability to trade[268] and may explicitly request that companies not divulge any nonpublic information in their private meetings. Moreover, not every hedge fund collaboration requires insiders to disclose nonpublic information. For example, if a hedge fund is seeking to influence operational decisions, it is likely, at least in the initial stages of collaboration, to be providing rather than seeking information, as evidenced by the fund's

266. *See* McCahery et al., *supra* note 157, at 2906 (presenting survey results in which shareholders report their frequent use of private engagements with management and directors and describe those engagements as important).

267. *See Regulation FD*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm [https://perma.cc/EG78-PZSA] (last updated June 4, 2010). As put by one asset manager, when the SEC guidelines are taken into account, Regulation FD concerns sound "more of an excuse cited by issuers than an actual obstacle." MARC GOLDSTEIN, INSTITUTIONAL S'HOLDER SERVS., THE STATE OF ENGAGEMENT BETWEEN U.S. CORPORATIONS AND SHAREHOLDERS 20 (2011), https://www.weinberg.udel.edu/IIRCiResearchDocuments/2015/09/IRRC-ISS_EngagementStudy1.pdf [https://perma.cc/PGV7-UQKV].

268. Hedge fund representatives are well aware that their access to confidential information may limit their ability to trade. For example, Mark Cuban reportedly responded after allegedly receiving confidential information about Mamma.com's planned PIPE offering, "Well, now I'm screwed. I can't sell." Rachelle Younglai & Robert MacMillan, *SEC Charges Mark Cuban with Insider Trading*, REUTERS (Nov. 17, 2008, 6:10 PM), https://www.reuters.com/article/us-sec-markcuban/sec-charges-mark-cuban-with-insider-trading-idUSTRE4AG5IM20081118 [https://perma.cc/3NEU-FJ5L]. Cuban was subsequently charged with insider trading, but a jury determined that he was not liable. Jana J. Pruet, *Billionaire Mark Cuban Cleared of Insider Trading; Blasts U.S. Government*, REUTERS (Oct. 16, 2013, 2:44 PM), https://www.reuters.com/article/us-usa-sec-cuban-verdict/billionaire-mark-cuban-cleared-of-insider-trading-blasts-u-s-government-idUSBRE99F0ZM20131016 [https://perma.cc/8RHR-45WH].

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frequent preparation of extensive business plans and proposals.[269] Nonetheless, some collaborations require two-way communication of the private information possessed by both investors and insiders. Because of the hedge fund's prior investment in developing firm-specific information as well as its likely expertise, engagement is likely to be most productive when the company and the fund can share their partial information to deliberate and aggregate that information. Moreover, when hedge fund representatives serve as directors or board observers, they necessarily will become privy to material nonpublic information.

Insiders have cited the potential misuse of information as a basis for limiting the access of activist directors to confidential firm information.[270] Some companies have even responded to the appointment of activist directors by forming executive committees of the board to "wall off" an activist director from information or deliberations.[271] Legally, however, activist directors are entitled to equal access to corporate information as their fellow directors in order to fulfill their fiduciary obligations to the company.[272] Activist directors are unlikely to collaborate effectively without such access.

A more complex issue concerns the ability of hedge fund directors or representatives to share information with others at their fund. Recall that the collaborative model relies on the fact that shareholders supply complementary information due to their information advantages in the market, expertise, and differential knowledge base. This information is not contained within the brains of the hedge fund's directors but located throughout the fund. For activist directors to operate effectively, they must be able to evaluate company-specific information in the context of the fund's knowledge base. This necessarily will involve sharing firm-specific information with other fund representatives.

Whether such sharing is legally permissible has been the subject of extensive debate. A number of commentaries have claimed that constituency

269. As Trian principal Ed Garden explains, the purpose of Trian's initial private meetings with management is to explain its analysis. "We want to get their opinion of our work. After all, we've done this from the outside and don't have perfect information. We'd rather be rich than right." LUIS M. VICEIRA ET AL., HARV. BUS. SCH., TRIAN PARTNERS AND DUPONT (A) (2017).

270. *See, e.g.*, Lindsay Frost, *Activist-Appointed Directors Causing Confidentiality Concerns*, AGENDA (Apr. 4, 2016), https://www.conference-board.org/retrievefile.cfm?filename=AgendaWeek-040416.pdf&type=subsite [https://perma.cc/6JDR-WYP4].

271. *E.g.*, Christopher P. Skroupa, *Onboarding an Activist-Nominated Director — Best Practices, Risks and Mistakes to Avoid*, SKYTOP STRATEGIES (Jan. 23, 2018), https://skytopstrategies.com/onboarding-an-activist-nominated-director-best-practices-risks-mistakes-to-avoid/ [https://perma.cc/Q7KF-MSFY] (explaining that "[t]he formation of an executive committee effectively walls off the activist investor's nominees from most of the board's deliberations").

272. *E.g.*, Hall v. Search Capital Grp., Inc., No. 15264, 1996 WL 696921, at *2 (Del. Ch. Nov. 15, 1996) ("When management communicates with the directors on matters of concern to the Board collectively, it cannot pick and choose which directors will receive that information. Absent a governance agreement to the contrary, each director is entitled to receive the same information furnished to his or her fellow board members.").

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directors navigate in perilous waters in transmitting information to their sponsors.[273] Overall, however, the relevant case law seems to suggest that activist directors *are permitted* to share firm information with their sponsors.[274] After all, as observed by Vice Chancellor Travis Laster and Mark Zeberkiewicz, a rule against information sharing would be both unrealistic[275] and potentially detrimental.[276]

Confidentiality agreements can address the concern that an activist director or fund may misuse material nonpublic information. Indeed, the use of such agreements is common practice when companies find it beneficial to communicate material nonpublic information to shareholders.[277] For example, after Trian's unsuccessful proxy contest against DuPont, DuPont officials invited Trian to collaborate with them in developing the structure of DuPont's subsequent merger with Dow Chemical and split into three independent companies.[278] Because the fact and terms of the merger and the subsequent spin-offs were, at the time of these negotiations, nonpublic and highly market sensitive, Trian participated pursuant to a confidentiality agreement.[279]

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273. *See* Robert Little & Chris Babcock, *Walking the High Wire: Guidelines for Board of Director Designees of Private Equity Funds, Activist Stockholders and Other Investors*, 44 SEC. REG. & L. REP. 2245, 2246 (2012) (claiming that directors' duty of confidentiality to the company prevents directors from sharing confidential information with anyone who is adverse to the company, even when the adverse parties are significant stockholders); Veasey & Di Guglielmo, *supra* note 243, at 773–74 (describing the tension between directors' duty to protect confidential information and their responsibility to be their sponsors' "eyes and ears").

274. *See, e.g.*, Schoon v. Smith, 953 A.2d 196, 208–09 (Del. 2008) (implicitly confirming that constituency directors can share information with their sponsors); Kalisman v. Friedman, C.A. No. 8447-VCL, 2013 WL 1668205, at *6 (Del. Ch. Apr. 17, 2013) ("When a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director.").

275. *See* J. Travis Laster & John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 BUS. LAW. 33, 52–53, 55 (2015) ("This rule reflects the practical reality that director representatives in both public and private companies routinely share confidential corporate information with colleagues at their affiliated investment funds.").

276. *Id.* at 55 (arguing that a rule against information sharing would entail both a breach of duty of blockholder directors as corporate insiders and investors' fiduciaries).

277. *See* Jordan Schoenfeld, Action-Based Contracts Between Firms and Shareholders 19 (Dec. 2018) (unpublished manuscript), http://www.bm.ust.hk/acct/files/Accounting%20 Symposium/2018/_Shareholder_Contracts.pdf [https://perma.cc/XS7J-4UHU].

278. David Benoit, *Dow, DuPont Deal Cements Activists' Rise*, WALL ST. J. (Dec. 11, 2015, 9:52 PM), https://www.wsj.com/articles/dow-dupont-deal-cements-activists-rise-1449882586 [https://perma.cc/3AN5-KBEA].

279. DowDuPont Inc., Final Proxy Statement/Prospectus 73 (Form 424B3) (June 10, 2016) (describing meetings between a DuPont executive, a DuPont financial advisor, and four Trian representatives, pursuant to a nondisclosure agreement to discuss, inter alia, "strategic rationale of the product portfolios and the optimal allocation of businesses among the public companies resulting from the potential post-merger separation").

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Confidentiality agreements largely address legal and practical concerns over the potential misuse of information.[280] The SEC has explicitly stated that confidentiality agreements are an appropriate way for insiders to limit their potential liability exposure under Regulation FD.[281] Similarly, SEC rule 10b5–2 prohibits anyone who receives material nonpublic information pursuant to a confidentiality agreement from trading on that information.[282] Accordingly, the use of a confidentiality agreement clarifies both the fact that investors may not use confidential information from their collaborations with insiders for the purpose of securities trading and the terms on which investors may share information, such as to others at their firm.[283] For the hedge fund activist, a confidentiality standstill agreement is also likely to be valuable in that it provides an enforceable commitment by the activist to maintain its equity position in the issuer as it seeks to work to effect change.

Confidentiality agreements are not a perfect solution to concerns about the misuse of corporate information, however. First, insistence on confidentiality agreements as a prerequisite to engagement may chill potentially valuable collaborations. As noted above, many investors have liquidity needs that prevent them from limiting their ability to trade, and as a result, they cannot sign a confidentiality agreement as a condition to meeting privately with insiders. Second, there is a risk that confidentiality agreements will be overused. Although collaborating shareholders should not misuse information, they should not be held to a higher standard than insiders. Corporate officials are free to trade in their company's stock with appropriate safeguards such as a requirement that trades be preapproved or take place only during specified trading windows.[284] Collaborating investors should also

280. Coffee et al. also find evidence that the use of confidentiality agreements in negotiated settlements of proxy contests is correlated with less information leakage following the appointment of hedge-fund-nominated directors to the board. Coffee et al., *supra* note 258, at 423–24.

281. *Regulation FD*, *supra* note 268 ("[B]ecause Regulation FD does not apply to disclosures made to a person who expressly agrees to maintain the disclosed information in confidence, a private communication between an independent director and a shareholder would not present Regulation FD issues if the shareholder provided such an express agreement.").

282. 17 C.F.R. § 240.10b5–2 (2018).

283. *See, e.g.*, David A. Katz, *Boardroom Confidentiality Under Focus*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 23, 2014), https://corpgov.law.harvard.edu/2014/01/23/boardroom-confidentiality-under-focus/ [https://perma.cc/9GJV-7XRT] ("Having a detailed and robust board confidentiality policy will serve both to advise directors (and their sponsors, if any) as to their obligations with respect to sensitive board information and to create a board culture that views leaking as unacceptable and dishonorable behavior."). For example, when Pershing Square named Stephen Fraidin to the board of Valeant as part of a settlement agreement, Fraidin wrote a letter to then-CEO Michael Pearson stating: "I hereby undertake, consistent with my fiduciary duties and confidentiality obligations as a Valeant director, to refrain from communicating to anyone (whether to any company in which we have an investment or otherwise) confidential information I learn in my capacity as a director of Valeant; *provided that I may communicate such information to members of my firm*, Pershing Square." Frost, *supra* note 270 (emphasis added).

284. Corporate officers and directors are also subject to the short-swing trading limitations of § 16(b). 15 U.S.C. § 78p (2018). Those restrictions apply equally to activist-nominated directors.

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be free to trade on these terms. Along similar lines, Delaware law imposes a duty of confidentiality on directors as part of their duty of loyalty.[285] That duty requires all directors, including shareholder-nominated directors, to maintain material company information confidential without the need for a confidentiality agreement.[286] Finally, some commentators have raised the concern that issuers may use confidentiality agreements to "oppress directors,"[287] although such a concern appears more likely when a hedge fund has obtained board seats through confrontation rather than collaboration.

C. Collusion

Lastly, shareholders and insiders may also use collaboration to engage in collusive behavior—behavior that is contrary to the interests of other shareholders or the public generally. A developing literature, initiated by two papers examining the airline and banking industries respectively, explores the possibility that institutional investors may collude to reduce competition.[288] The argument in these papers, which focus primarily on mutual funds, is that common ownership creates an incentive for investors to favor anticompetitive behavior to generate monopolistic profits.[289] Notably, these profits have the potential to benefit both insiders and investors. The authors support their theory by showing that the airline and banking industries have experienced increased ownership concentration and, at the same time, reduced competition.[290] Although the literature is too extensive to examine here, and we note that the empirical results of the Azar et al. research

285. Cyril Moscow, *Director Confidentiality*, LAW & CONTEMP. PROBS., Winter 2011, at 197, 200. The duty of confidentiality is part of a director's general duty of loyalty. Sepe, *supra* note 58, at 344; *see also* Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 693 (2009); Charles M. Nathan, *Maintaining Board Confidentiality*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 23, 2010), http://blogs.law.harvard.edu/corpgov/2010/01/23/maintaining-board-confidentiality [https://perma.cc/F76K-6ARR].

286. *See, e.g.*, Malone v. Brincat, 722 A.2d 5, 12 (Del. 1998) ("The directors' duty to disclose all available material information in connection with a request for shareholder action must be balanced against its concomitant duty to protect the corporate enterprise, in particular, by keeping certain financial information confidential."); COMM. ON CORP. LAWS, ABA SECTION OF BUS. LAW, CORPORATE DIRECTOR'S GUIDEBOOK (5th ed. 2007), *reprinted in* 62 BUS. LAW. 1479, 1500 (2007) ("A director must keep confidential all matters involving the corporation that have not been disclosed to the public.").

287. Frost, *supra* note 270 (quoting director Charles Elson).

288. *See generally* José Azar, Martin C. Schmalz & Isabel Tecu, *Anti-Competitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018) [hereinafter Azar et al., *Anticompetitive Effects*] (airline industry); José Azar, Sahil Raina & Martin C. Schmalz, Ultimate Ownership and Bank Competition (May 4, 2019) (unpublished manuscript), https://ssrn.com/abstract=2710252 [https://perma.cc/G2YH-RQNQ] [hereinafter Azar et al., Ultimate Ownership] (banking industry).

289. Azar et al., *Anticompetitive Effects*, *supra* note 289, at 1514; Azar et al., Ultimate Ownership, *supra* note 289, at 2.

290. Azar et al., *Anticompetitive Effects*, *supra* note 289, at 1517; Azar et al., Ultimate Ownership, *supra* note 289, at 2–3.

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have been challenged on a variety of bases,[291] the bottom line is that collusion between insiders and investors is possible and the novel collaborative patterns that we describe in this Article may offer an important vehicle for collusion.

Conclusion

Both the prevailing models of the public corporation frame the insider–shareholder relationship in terms of a competitive struggle. On this shared premise, the "battle" between defendants of each model focuses on the question of the appropriate allocation of power between corporate insiders and shareholders to reduce the risk of managerial moral hazard.

This Article showed that the reality of the insider–shareholder dynamic has turned increasingly collaborative. In a coherent, if unheralded, effort, insiders and newly empowered shareholders are joining forces to promote deliberative mechanisms for increasing firm value through a variety of means that include shareholder engagement, private initiatives to develop shared governance principles, and "constructivist" activism. Despite these dramatic transformations, corporate law scholars have paid limited attention to shareholder collaboration. This Article provided a first attempt at remedying this gap, exploring the implications of the rise of shareholder collaboration.

Descriptively, the rise of collaboration in the public corporation is not a casual occurrence but can be traced back to the VC context, where founders and investors have long developed structures to promote joint decision-making. Changes in the public-company context have expanded the role of collaboration. Under these changes, the normative task is no longer only to determine the appropriate balance of shareholder and manager power. Rather, it is also to determine the best way to aggregate the partial and complementary information that insiders and shareholders are likely to possess in a world of complex investments and reconcentrated equity ownership. As this Article has shown, collaboration offers a means to that end that neither unilateral decision-making nor the mediated transmission of information through markets can provide.

Policywise, the collaborative model has several implications. By enhancing shareholder influence over firm decisions, collaboration creates the potential for conflicts of interest, the risk that shareholders may misuse firm-specific information, and the possibility of collusive behavior. Existing corporate law tools such as fiduciary duties and confidentiality agreements

291. *See, e.g.*, Patrick Dennis et al., Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry 34 (Aug. 14, 2019) (unpublished manuscript), https://ssrn.com/abstract=3063465 [https://perma.cc/RVS4-Y776] (critiquing the Azar et al. airline study); Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance* 2 (N.Y. Univ. Sch. of Law, Law & Econ. Research Paper Series, Working Paper No. 17-05, 2017), https://ssrn.com/abstract=2925855 [https://perma.cc/WD2W-LZR7] (same).

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are poorly designed to address these concerns without sacrificing the potential value of collaboration. Consequently, the growing importance of collaboration requires rethinking and adapting several existing principles of corporate law. This Article begins the task; we hope that its observations can provide a starting point for much needed future research on the new collaborative model of the public corporation.

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