

ALI-ABA Corporate Governance: The Changing Environment
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*Shareholders, Directors, and
Management in Dialogue*

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Remarks by
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Introduction

We lawyers play a critical role in counseling our public company clients about their governance today recognizing the significant changes that have, and are, taking place in the capital markets.

These changes, most notably in the pattern of share ownership of U.S. companies (which I will go into more detail in a minute), have complicated the debate on a number of hot button governance issues: CSR, executive compensation, shareholder access to the proxy, U.S. competitiveness, management entrenchment devices, and, most important to me, short-termism. The increasingly heterogeneous shareholder population has raised

a host of questions for directors who must now exercise their fiduciary responsibilities among potentially divergent shareholder interests.ⁱ

While debate on the merits of these issues continue, I suggest communication. I believe almost every hot button governance issue can be addressed through constructive communication between boards and management with shareholders. I see communication as the alternative to hostile interactions, additional mandated disclosures or other hurried regulation, and litigation. Both the “law” and “lore” of such communications are muddled.

This is where lawyers can have a positive impact. Our challenge is to encourage and enable boards and managers to effectively communicate with shareholders in a less formal, but more informative and candid manner, and hopefully avoid contentious proxy resolutions, new regulations and litigation.

Professor Robert C. Clark, the former dean of Harvard Law School, clearly captured the generic opportunity for lawyers in a recent article:

The implications [of these capital market changes] for the judicial elaboration of directors’ fiduciary duties and other aspects of corporate law have yet to be worked out. In my opinion, corporate law scholars have an historic opportunity to help shape the path of the law through this new and bewildering forest.ⁱⁱ

Communication is one key to reshaping the path of the law, to guide us through this new capital market. Lawyers can help companies devise meaningful ways of communicating with shareholders.

Let's first take a look at how communication may help corporations and shareholders address a number of current issues in corporate governance. Then we'll examine the "how to" of communication.

- Societal Concerns, Including Climate Change and Other Issues:

The company's role in society including social and environmental issues such as climate change, labor issues, political contributions and the like, can be addressed through board/shareholder communication.

Exchanges with shareholders will help the board determine whether resolution of any of these issues properly lies with the government and how much can be accomplished by the corporation. The answers will depend on the "values" placed by shareholders on such issues. Values, I suggest, may very well vary for each corporation depending on the nature of the business and the heterogeneity of its shareholders. And is, therefore, a company by company issue.

- Compensation:

Do we need a "say on pay" regulation or can honest communication and candid disclosure bring about a better understanding on the part of

shareholders? In the UK “say on pay” rules brought not limits on pay, but greater communication and less contention. I suggest we may not need a similar U.S. rule if candid and informal communication with shareholders opened up voluntarily. Of course, if companies remain closed to this approach, a “rule” will likely follow given the heat generated by the compensation issue. Again, this is a company by company issue – there is no generic solution to compensation.

- Board Membership and Candidates:

Do we need regulation to allow shareholder access to the company’s proxy materials? Many shareholders insist on being able to use company materials to advance shareholder nominees. Understandable. But wouldn’t voluntary adoption of majority voting and a candid interchange between the board’s governance committee and shareholders on the subject of board composition and membership alleviate the demand for access? Or, at least, limit the circumstances where access be made available. Communication may lead to tailoring access and decrease the contention surrounding the issue.

- U.S. Competitiveness: The Rising Costs of Litigation and D&O

Insurance:

Arguably, one of the major threats to U.S. competitiveness is rising litigation and D&O costs. According to the Committee on Capital Markets Regulation,ⁱⁱⁱ chaired by Professor Scott, and on which I served, class action settlement costs have increased from \$150 million in 1995 to \$3.5 billion in 2005 (leaving out the \$6.1 billion settlement in Worldcom), and director and officer (D&O) insurance rates are six times higher in the United States than in Europe.^{iv}

If shareholders are given the chance to voice their concerns about corporate governance and strategy to boards early on, they may be less likely to sue and there may be fewer cases filed against well-performing companies. Moreover, in the event that a suit is filed, companies will be in a better position to defend against it successfully. More cases may be dismissed on motion, or, at a minimum, the probability of damages being assessed may be reduced. Again, however, this is a company by company approach.

- Defenses to Potential Threats from the Capital Markets:

Poison pills, staggered boards, and the like are often viewed by shareholders as entrenchment tools for management. Yet these same defenses give boards time to respond appropriately to hostile threats from potentially short term oriented market participants. Shareholders need to understand that these defenses can be crafted in such a way as to serve, not as management entrenchment devices but rather to protect the overall long term interest of the corporation. Again, communication can accomplish this understanding once a context of trust is created. Law Review analyses on this subject don't reach shareholders, communication by a respectable board, might.

- Short and Long Term Strategies:

Capital market participants, as we will see, have different and often conflicting motivations as "owners." Boards will need to decide how to deal with these inherent conflicts by communicating to the market their achievable long term strategies for the company. Indeed, long term investors should be attracted to companies that have clearly articulated and sensible long-term strategies.

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For these, and other reasons, I see communication between the board and management with shareholders as a necessary first step. It may not solve everything, but it surely can't hurt. The challenge for lawyers is to develop and shape meaningful channels for effective communication.

To appreciate and successfully meet this challenge, we need next to understand why the new capital markets virtually demand un-circling the wagons and opening up communications between boards and management with shareholders.

I. The Changing Pattern of Share Ownership in Today's Capital

Market: Who are the New Shareholders?

Today's capital markets are very different than they were 50, 20, or even 10 years ago. Beginning in the second half of the 20th century, we've seen considerable changes in the patterns of shareownership, complemented by technological advances, globalization, and the rapid and continuous proliferation of complex financial instruments.

Since the 1960s, shareownership has become increasingly concentrated, first by the pension and mutual funds, and more recently by private pools of capital, such as hedge funds, private equity, and a host of new intermediaries all of whom invest "our" money. Remember, you and I

are the “savers” who once invested directly in public corporations, but now, for most of us, our money finds its way to these new intermediaries, who in turn are the shareholders. Furthermore, we see the increased presence of sovereign wealth funds and other government organizations. All of these new shareowners vary significantly in their strategies, objectives, and time horizons. As compared to the more traditional institutional investors, some of the newer private pools of capital are more active, better incentivized, and many have shorter investment horizons.

Their Impact

To illustrate how critical communication is in the new capital markets I would like to focus on one particular hot button issue, supporting long-term value creation in the face of increased short term pressures. In response to these new and varied shareholder interests, communication between boards and management with long-term shareholders is critical to building shareholder support for management’s long term plans.

The arrival of new investment vehicles, along with other changes in the capital markets, has created pressure on boards to focus on the short term movement of stock prices. For example, activist hedge funds may urge boards to raise the stock price in the short term through a stock buy-back, a special dividend, or the sale of an asset. Private equity may offer to buyout

management and public shareholders at a premium over the current market price, with the hope of exiting their investment profitably, over time.

Boards, in order to deter or improve such private equity “deals” may seek to boost share prices in the short term, often sacrificing long term achievable strategies for the company.

Moreover, these pressures may trigger the adoption of takeover defenses (poison pills, staggered boards), and compensation arrangements (golden parachutes) designed for such “just in case” events. As noted earlier, the adoption of these arrangements by the board, with the interest of giving management time to fulfill its long term plans, are often viewed by shareholders as an anti-shareholder stance. Communication is key to avoiding such misunderstandings between the board and its shareholders.

Although I can not “prove” that these short term pressures exist, with potentially adverse effects on the vitality of our public corporations, the Center for Corporate Governance & Performance at the Yale School of Management is hard at work attempting to find more definitive evidence. In the meantime, based just on observing what is going on “out there,” I believe it to be so.

In addition to being more short term oriented than institutional investors, some of these new investors are often more active, more vocal,

and more aggressive than traditionally passive institutional investors. This may become apparent when interests among shareholders of a company diverge.

For example, a value hedge fund that owns substantial stock may threaten a proxy contest to exert pressure in favor of a large buy-back program. Other private pools of capital with short term profit motivations will welcome this offer. But pension funds and other institutions interested in long term value growth may oppose the buy-back offer as a waste of cash which could be more properly dedicated to capital improvements.

The Board's Response

Such potential conflicts of interests among shareholder groups impact decision-making by boards. Diverging interests and agendas raise questions about whether these changes in patterns of share ownership alter or modify in any way the board's fiduciary duty. As Professor Clark suggested, we lawyers have a historic opportunity, and need, to think this through:

[t]he law of fiduciary duties may be fought over, rethought, and spelled out in extremely interesting new ways to deal with intra-shareholder and intra-security holder conflicts. Astute corporate scholars will have a chance to propose the definitive analysis and ideal solution.^v

In my view, shareholder primacy is still the right model; the board, with management, is responsible for maximizing shareholder value in the long term.^{vi} Simple enough in theory, but ever more difficult in practice. To begin with, however, the board must communicate with shareholders in order to better understand the challenges of the new capital markets and then exercise its business judgment accordingly. It must make decisions, based not on suppositions, but rather on an actual understanding of the varied interests of shareholders, an understanding that can be built on good communications. As Margaret Blair and Lynn Stout put it, the board assumes the role of the “mediator.”^{vii}

Take, for example, the question of whether to heed the pressure of a hedge fund for a special dividend, asset sale, or a stock buy-back. If the board believes it has a viable strategic long term plan in place, which discounted to present value tops the return in the short term, but which has not been appropriately reflected in current share price, it can communicate its plans to the long term shareholders of the company. The board should explain why its plan, rather than that of the activist investor, would create more value in the long term. But the plan must be legitimate and understandable, not the customary hockey stick.

If the board effectively communicates management's plan, and the plan is reasonably believed to be in the long term interest of the corporation, the board and management should not fear the capital markets. They should feel confident that the company's institutional shareholder base as a whole can support their decision.

The Shareholder Response

For board/shareholder communication to be effective, institutional investors need to act responsibly and fully participate in order to take advantage of this dialogue. Institutional investors should be making decisions in the interests of their beneficiaries who have longer investment horizons and investment needs, rather than acting in their own self-interest.^{viii} They must do their homework, have the necessary information, and valuation systems needed to understand management's plan.^{ix} Only when they are fully informed and understand management's plan can they properly assess whether to support a change in strategy or governance.

A caveat

Admittedly, even given the best communication, short termism may still persist because markets are not perfect and different market participants have different information; board members, management, and shareholders may have non-financial reasons for making decisions not in the long term

interest of the corporation (the original Dow Jones decisions, for example); and board members and management may make short term decisions for personal gain, motivated by stock options or considerations of power and prestige.

Despite these market imperfections, good communication is the best means for assuring that corporations remain focused on improving value over the longer term, given the heterogeneity of the new “owners.” I can see no down side to communication.

II. The Means of Communication

Now back to the beginning – the question for lawyers: How do boards effectively communicate? To which shareholders should boards be talking and what should they be communicating? Are there legal limits on this type of dialogue?

The Existing Legal Framework

The rules around communication between boards and shareholders are rather limited and offer little guidance. The basic rules are found in the SEC’s Regulation Fair Disclosure (“Reg FD”) which governs selective disclosure and, to a lesser degree, the proxy rules and the NYSE listing standards. On the whole, the trend in recent years has been to facilitate communications with and among shareholders.

- In 1992, the SEC facilitated communication between shareholders when it amended the proxy rules to exempt from the proxy statement requirements most communications among shareholders that do not request a proxy. Prior to the amendment, more than 10 shareholders could not communicate with each other or make public their views on matters relating to a company's proxy solicitation without preparing a proxy statement.^x
- In November 2003, the SEC adopted new proxy statement disclosure rules addressing board and shareholder communications.^{xi} Under these new rules, companies are required to disclose in their proxy statement whether or not they have procedures for shareholders to suggest director candidates. Any company without such processes in place must explain why the board believes that providing such means for communication is not appropriate.
- In 2003, the NYSE revised its listing standards to require companies to disclose the process by which interested parties including shareholders could communicate directly with the

presiding director or the non-management directors of the board.^{xii}

- Effective this month, the SEC has further amended its proxy rules to facilitate shareholder communications through electronic forums; provided that, such forums are not used directly or indirectly to solicit proxies and do not furnish or otherwise request any form of revocation, abstention, consent or authorization. In general, such communications may be made without preparing a proxy statement if made at least 60 days before a shareholder meeting.^{xiii} The SEC also clarified that each forum participant would only be liable under the federal securities laws for their own statements and not that of other participants.

These above-mentioned regulations have largely facilitated one-way communication between boards and shareholders or between shareholders themselves.

Reg FD which requires public disclosure whenever “material nonpublic information” is disclosed by a company to selective parties, may create some concern for companies interested in having a dialogue with shareholders. Companies may worry that any executive or director who

communicates, directly or indirectly, with a shareholder or group of shareholders could accidentally disclose material information, forcing the company to make a prompt public disclosure. Moreover, a director might not realize his or her error and fail to inform the company of any inadvertent disclosures.

Reg FD was not intended to prohibit open dialogue. It was created to promote prompt, full and fair disclosure to all shareholders. Executives and directors can have important discussions with shareholders without violating Reg FD. The Center at Yale will release next week a set of findings underscoring this point, and outlining various models companies have used to experiment with constructive dialogue. For example, UnitedHealth and Pfizer have announced they will meet regularly on governance matters with their major shareholders. To ensure that communications are within legal bounds, participating executives and board members should be adequately advised on the company's "Reg FD Communication Policy," ground rules should be developed to govern discussions, and participating investors should be advised of these ground rules.^{xiv} Executives and board members should have access to the general counsel or independent counsel at such meetings to advise on possible Reg FD issues in real time.^{xv} Executives and

boards should also realize that communicating with its shareholders is a real opportunity to listen.

A report commissioned by the NACD and the CII entitled “Improving Board-Shareowner Communications” concluded that for the most part the board/shareholder communications, including phone conversations and in-person meetings, can address corporate governance and similar issues that would not involve disclosure of material, non-public information subject to Reg FD.^{xvi} Care must be taken however that the discussion of governance matters not be interpreted as a disclosure of financial performance indicators, resulting in possible Reg FD violations. To help address these concerns, the areas for discussion at such meetings should be outlined in advance and participating executives and directors should be familiar with what has been disclosed by the company on matters such as earnings guidance.

Given the few instances of board/shareholder communication, many believe that boards do not want to communicate. However, the report by the the NACD and the CII concluded that boards do want to be able to communicate with their shareholders but lack clear examples of how to achieve such effective dialogue.^{xvii} Recommendations included in this report, as reflective of the times, focused on the board opening its doors to

shareholders. What I am focusing on is lawyers encouraging boards to be proactive in its communications with its shareholders.

This is the real challenge for lawyers to help solve.

Counsel should advise clients in a way that makes them comfortable with, rather than to discourage, constructive communication. Counsel should advise their clients that Reg FD is a caution, not a barricade. They should sit with the boards and design “shareholder communication” procedures which are tailor-made to suit the best interests of the company given its size, shareholder base, past governance issues, and the like.

III. The Limits:

Board and shareholder communication has to be a mutual two-way process built on mutual trust and respect. Boards and investors need to stop thinking of board-shareholder communication in an adversarial context, as if one side must win over the other. Such a posture will completely destroy the very purpose of having the dialogue. Mutual distrust will lead nowhere.

And shareholders should recognize and respect that there are limits on the issues that are appropriate for shareholder initiatives. Board and shareholder meetings may serve as a forum to discuss the limits of shareholder power. Where is the legitimate boundary? Long ago owners gave up rights to control the joint stock company in return for limited

liability—and directors took fiduciary responsibility. If shareholders insist on ever-greater say in corporate decision making, at what point do we need to rethink shareholder and director responsibility – and liability?^{xviii}

IV. Conclusion

Summing up: the continuous changes in U.S. capital markets in the past 30 years are altering the traditional roles which boards and shareholders play. Shareownership in the U.S. is now more concentrated in the hands of institutional investors and private pools of capital. These investors not only are different from each other in their investment philosophy and strategy, but many wish to have a more active role in corporate decision making -- thereby making it more difficult for the board to accommodate all the divergent interests. Yet the board must be the “mediator” – there’s no one else. Consequently, the traditional interplay between the role of the board and its shareholders now needs to be re-examined, given these changes. Communication can only help.

The challenge for lawyers is: how best to structure communication; when to listen; how much to listen; when to respond to certain activists; how to involve long term value owners, which ones, and how to manage the communication process. Appropriate best practices need to be developed to

allow and determine the boundaries of this dialogue. This is our task as lawyers.

ⁱ Robert C. Clark, *Major Changes Lead us Back to Basics*, *Journal of Corporation Law* 591 (2006).

ⁱⁱ *Id.*, at 594.

ⁱⁱⁱ Interim Report of the Committee on Capital Markets (November, 2006) available at http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf

^{iv} *Id.*, at p. 46.

^v Robert C. Clark, *Major Changes Lead us Back to Basics*, at 598.

^{vi} The ALI Principles of Corporate Governance (§ 2.01).

^{vii} Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, *Journal of Corporation Law* 719, 737 (2006).

^{viii} International Corporate Governance Network (ICGN): Statement of Principles on Institutional Shareholder Responsibilities, available at <http://www.icgn.org/organisation/documents/src/Statement%20on%20Shareholder%20Responsibilities%202007.pdf>.

^{ix} Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital [Principle 9].

^x Ernie Englander & Allen Kaufman, *Managerial Fiduciary Duty and Social Responsibility: The Changing Nature of Corporate Governance in Post-War America*, SMPP Working Paper 03-04, George Washington University School of Business and Public Management, p.58 (2004).

^{xi} The November 2003 Rules Release is available at <http://www.sec.gov/rules/final/33-8340.htm>.

^{xii} Commentary to NYSE, Rule 303 A.03.

^{xiii} The January 2008 Rules Release is available at <http://www.sec.gov/rules/final/2008/34-57172.pdf>.

^{xiv} UnitedHealth, “Nominating Advisory Committee” charter, available at http://www.unitedhealthgroup.com/about/Advisory_Committee_Description.pdf.

^{xv} Framework and Tools for Improving Board-Shareowner Communications, p. 9 (2004), available at <http://www.nacdonline.org/images/White-CIITaskForce-2004-2-26-04.pdf>.

^{xvi} *Id.*

^{xvii} *Id.*

^{xviii} Ira Millstein *et al.*, *Meetings Between Directors and Institutional Investors on Governance Matters are a Constructive Step*. (June 29 2007).