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Jill E. Fisch
University of Pennsylvania Law School

Simone M. Sepe
University of Arizona

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Shareholder Collaboration

Jill E. Fisch* and Simone M. Sepe ±

Abstract

Two models dominate the debate on the theory of the firm. Under the management-power model, decision-making power exclusively belongs to corporate insiders (officers and directors). The competing shareholder-power model contemplates increasing shareholder power to limit managerial authority. Both models are focused on managerial agency costs and address the appropriate allocation of power between insiders and shareholders to minimize these costs. Both models also assume that insiders and shareholders are engaged in a competitive struggle for corporate power.

Corporate practice has moved on, however. Increasingly, the insider-shareholder dynamic is collaborative, not competitive. This Article traces the development of insider-shareholder collaboration and constructs a taxonomy of the novel collaborative model. It first explains how collaboration originated in the venture capital context and then explores the circumstances surrounding the expansion of collaboration into public companies. Most importantly, corporations today face partial information costs that, for many firms, have grown costlier than agency costs. Using insights from game theory, the Article demonstrates how collaboration promotes the production and aggregation of the partial information of insiders and shareholders, adding value that is lost under unilateral decision-making by either the board or the shareholders.

The growing importance of shareholder collaboration requires rethinking several principles of corporate law. By enhancing shareholder access to information, collaboration creates the risk that shareholders may misuse that information. Similarly, shareholder influence on operational decision-making challenges doctrines that limit the fiduciary obligations of non-controlling shareholders. Finally, both shareholders and insiders may use the collaborative process to engage in collusive behavior or self-dealing.

TABLE OF CONTENTS

INTRODUCTION 2

I. FROM CONFRONTATION TO COLLABORATION 6
- A. Traditional Corporate Models 7
  - 1. The Management-Power Model 7
  - 2. The Shareholder-Power Model 8
  - 3. The "Battle" between Insiders and Shareholders 10
- B. Private Ordering, Collaboration and Venture Capital 11
- C. The Rise of Collaboration in the Public Corporation 14
  - 1. Empowered and Informed Investors 14
  - 2. The Role of Independent Directors 16

* Perry Golkin Professor of Law, University of Pennsylvania Law School.

± Professor of Law and Finance, James E. Rogers College of Law, University of Arizona; and Institute for Advanced Study in Toulouse—Fondation Jean-Jacques Laffont—Toulouse School of Economics. We are grateful for comments received at the American Law & Economics Association Annual Meeting, 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.

3. Partial Information Problems and Shareholder Collaboration ... 16
II. SHAREHOLDER COLLABORATION: A TAXONOMY ... 18
A. Large Institutional Investors ... 18
1. Shareholder Engagement ... 18
2. Corporate Governance Vehicles ... 20
3. Policy and Regulatory Issues ... 22
B. Hedge Funds ... 23
1. Constructivist Activism ... 23
2. Settlement Agreements and Activist Directors ... 24
C. The Spectrum of Collaboration ... 25
D. Anecdotal Evidence ... 27
III. DEFENDING AND STRUCTURING THE COLLABORATIVE MODEL ... 30
A. Why Collaboration is Normatively Attractively ... 30
1. Information Complementarity ... 30
2. Information Aggregation through Markets v. Collaboration ... 33
B. The Value of Collaboration: An Illustration ... 35
C. Structures to Make Collaboration Incentive-Compatible ... 37
1. Economic Rights ... 38
2. Decision-Making Rights ... 39
IV. IMPLICATIONS OF THE COLLABORATIVE MODEL ... 41
A. Mis-use of Information ... 42
1. Shareholders at Large ... 42
2. Hedge Funds, Activist Directors and Confidentiality Agreements ... 44
B. Conflicts of Interest ... 47
C. Fiduciary Duties ... 50
1. Collaborating Shareholders ... 50
2. Activist Directors ... 52
3. Collaborating Insiders ... 53
CONCLUSION ... 54

INTRODUCTION

Legal and economics scholars have developed and debated theories of the firm since the groundbreaking work of Ronald Coase in 1937.[1] Two models have come to dominate the discourse. Consistent with Coase's account of the firm as a hierarchical organization,[2] the management-power model emphasizes the board's decision-making authority as the corporation's essential coordinating and monitoring mechanism.[3] The competing shareholder-power model de-

[1] *See* R.H. Coase, The Nature of the Firm, 4 ECONOMICA 386, 392 (1937).
[2] *See id.*, at 390-92.
[3] *See, e.g.,* 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 decision controller charged with monitoring and ratifying management decisions); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L.

emphasizes authority in favor of accountability, contemplating enhanced shareholder power as the means to ensure that corporate insiders—both directors and managers—are held fully accountable.[4]

Proponents of both models, however, agree on two things. First, they regard managerial moral hazard as the central problem of corporate law.[5] 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.[6] 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.[7] Second, both the management-power model and the shareholder-power model assume that insiders and shareholders are engaged in a competitive struggle for corporate power. Under this shared assumption, corporate law entails a narrative of recurring battles with winners and losers. This narrative dates back to the hostile takeover era of the 1970s and persists today, with shareholder activists having replaced corporate raiders as the champions of shareholder power.

Meanwhile, the corporate world has moved on. Increasingly, the insider-shareholder dynamic in the modern corporation is *collaborative*, not competitive. Although shareholders are no longer dispersed and passive but empowered, they are using their greater power not to wrest control from corporate insiders but to work together with insiders and bring new information and insights to operational decision-making.[8]

Shareholder collaboration with insiders is occurring in multiple ways—through direct shareholder engagement about matters of concern, the flourishing of private initiatives aimed at introducing shared governance principles, activist interventions oriented to the longer term, the appointment of activist directors and several other forms of "constructivist" activism.[9] Although collaboration coexists with and has not displaced hostile activism, the trend toward board-shareholder collaboration is spreading rapidly and systemically. Institutional investors are at the forefront of this trend. Breaking old patterns, they have increasingly issued statements that they support the long-term plans of companies, withheld support of short-termist activist campaigns

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REV. 547, 557-59 (2003) (describing board exclusive authority as essential to overcome the collective action problem affecting corporate production).

[4] *See, e.g.,* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 865-70 (2005) (arguing for giving shareholder 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 for a reform of corporate elections so as to give more power to shareholders).

[5] *See* Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1911 (2013); Simone M. Sepe, *Board and Shareholder Power, Revisited*, 101 MINN. L. REV. 1377, 1379, 1395 (2017).

[6] *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (reprint ed. 1982), at 84-89.

[7] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

[8] 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. 3 (July-Aug. 1994). *See also* Debra Mashek, *Collaboration: It's Not What You Think*, PSYCHOLOGY TODAY, Feb. 22, 2016, at 2 (distinguishing collaboration from networking, coordinating and cooperating).

[9] *See infra* Part II.A-B.

and increased efforts to work with boards of directors.[10] Further, although constructivist activism had traditionally represented the exception, the recent substantial growth in this form of activism suggests that it could potentially eclipse hostile engagement in the near future.[11]

These trends suggest that shareholder collaboration offers a distinctive mechanism for enhancing firm value that unilateral decision-making by either insiders or shareholders cannot provide. It is time for the theory to catch up with the practice. This Article fills the gap,[12] using insights from game theory to demonstrate how collaboration promotes the production and aggregation of the "partial" and "complementary" information that insider and shareholders are likely to possess in today's knowledge-rich economy, thereby increasing firm value.

We begin our analysis by challenging the shared positive and normative assumptions of the traditional models of the corporation. As a positive matter, these models' confrontational approach to the insider-shareholder relationship cannot explain the capacious framework of American corporate law. Within this framework, private ordering provides the primary vehicle for managing that relationship. Over time, private ordering has done so successfully by adapting the allocation of corporate power to the frequent turning points of corporate governance. This adaptive process has produced confrontational outcomes such as the hegemonic board of the managerial era[13] and recent hostile activism.[14] But private ordering has also produced collaborative outcomes, as highlighted most clearly by the venture capital (VC) context. Indeed, in the VC context, founders and investors have long developed structures that promote shared power and joint decision-making -- collaborating with rather than competing against each other.[15]

As a normative matter, the confrontational approach shared by the traditional models of the corporation prevents their proponents from acknowledging that maximizing firm value requires more than minimizing agency costs in the current corporate environment. There are two reasons. First, in the modern corporation, the productive process has grown increasingly knowledge-intensive. This makes it unlikely that any one individual or organization, including the firm's officers and directors, possesses the relevant information to respond effectively to *all* business challenges. As a result, today's corporations no longer face just classic issues of asymmetric information, where insiders are likely to have access to private information unavailable to (or not verifiable by) outsiders. Rather, corporations also confront what we call "partial information"

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[10] *See, e.g.,* Andrew Ross Sorkin, *BlackRock's Chief, Laurence Fink, Urges Other C.E.O.s To Stop Being So Nice to Investors*, N.Y. TIMES (Apr. 13, 2015), http://www.nytimes.com/ 2015/04/14/business/dealbook/blackrocks-chief-laurence-fink-urges-other-ceos-to-stop-being-so-nice-to-investors.html?_r=0 (discussing the letter sent by BlackRock CEO, Laurence Fink, in April 2015 to the CEOs of 500 of the nation's largest companies, in which Fink first voiced concerns against hostile activism).
[11] *See infra* note ---.
[12] One recent 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 insider-shareholder relationships.
[13] *See infra* notes --- and accompanying text.
[14] *See infra* notes --- and accompanying text.
[15] *See infra* Part I.B.

problems, under which *both* insiders *and* outsiders have access to private information not available to the other party.[16]

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. Under this change in the fact pattern, shareholders 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.[17] It follows that the success of many firms today is as likely to depend on the inside information of insiders as on the firm-specific outside knowledge of investors – again similar to what happens in the VC context.

By focusing exclusively on insider-shareholder competition and managerial agency problems, confrontational theories overlook the changes that have occurred in the information structure of the board-shareholder relationship and limit the scope for corporate governance to affect firm value.[18] Moving past those theories, this Article shows that the key to collaboration is that it provides a value-increasing mechanism for aggregating the partial and complementary information of insiders and shareholders absent a market mechanism to otherwise aggregate that information effectively. Both the effectiveness of the information transfer and the credibility of collaboration as a commitment device create incentives for the generation and aggregation of partial and complementary information.

The conclusion that shareholder collaboration adds to firm value raises a series of questions about the governance of collaboration, which this Article begins to examine by drawing on the theory of cooperative games. It derives two main insights. First, it shows that that the equity contract efficiently addresses collaboration's economic rights by ensuring that the surplus created by collaboration is shared by both collaborating and non-collaborating investors, as well as equity-compensated managers. Second, it demonstrates that a party's say over the collaborative process should be determined according to that party's marginal contribution to the surplus created by collaboration. This preserves the incentives to invest optimally in the production of complementary information and the collaborative process more generally.

The growing importance of shareholder collaboration also has several policy implications. Insiders and 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 firm

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[16] More technically, 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 Andersson, *Adverse Selection and Bilateral Asymmetric Information*, 74 J. ECON. 173, 173 (2001) (examining bilateral asymmetric information in the insurance context). For clarity, this Article uses the term "partial information" at the place of "bilateral asymmetric information."

[17] *See infra* notes __-__ and accompanying text.

[18] This conclusion does not exclude that confrontational theories may suffer from additional common limitations. *See, e.g.,* Sepe, *supra* note 5, at 1377 (examining the shortcomings arising from the failure of both the management-power model and the shareholder-power model to consider the problem of adverse selection). Neither it excludes that each theory may suffer from individual limitations, *see, e.g.,* William W. Bratton & Simone M. Sepe, Shareholder Power and Incomplete Markets (unpublished manuscript) (2017) (on file with authors) (focusing on the normative limitations of the shareholder-power model).

value. These risks of opportunism challenge existing principles of corporate law which operate largely from the premise of insider-shareholder confrontation. We identify three main risks. First, there is the risk that shareholders will gain access to firm-specific information as a result of the collaborative process and will mis-use that information to benefit themselves or harm the corporation. Second, there is the broader risk that both shareholders and insiders may engage in deviating behaviors by acting to further their private interests, jeopardizing the viability of collaboration. Third, there is the risk of shareholder-insider collusion that may sacrifice the interests of other shareholders or non-shareholder constituencies. As the Article shows, the existing tools to address these concerns — confidentiality agreements and fiduciary duties — are ill-suited for a collaborative context and should be rethought.

The rest of the Article proceeds as follows. Part I explains why the prevailing confrontational theories of the corporation have grown increasingly outdated with the rise of shareholder collaboration, both as a positive and normative matter. Part II offers a first taxonomy of the several forms of collaboration that are rapidly spreading in corporate practice. Part III defends the normative desirability of the collaborative model, drawing on insights from game theory to both explain how collaboration increases firm value and understand how to preserve the individual incentives of insiders and shareholders to collaborate. Part IV discusses the policy implications of the analysis.

I. FROM CONFRONTATION TO COLLABORATION

This Part argues that the traditional, "confrontational" models of the corporation have grown increasingly unable to capture the implications of modern corporate governance. Despite their differences, these models share common positive and normative assumptions. Positively, both models assume that insiders and shareholders are engaged in a competitive struggle for corporate power. Normatively, they both assume that the essential task of corporate law is devising the appropriate allocation of power between insiders and shareholder to minimize the cost of managerial moral hazard.

We challenge both assumptions. As a positive matter, in the capacious framework of American corporate law, a mandated adversarial model is nowhere to be found. Private ordering,[19] instead, is the primary vehicle for managing the insider-shareholder relationship. Private ordering has successfully responded to economic and legal developments by adjusting that relationship with responses ranging from the hegemonic board of the managerial era to contemporary shareholder empowerment. Yet, it is a mistake to conclude from these responses that a confrontational model is an inherent feature of corporate law. The clearest counter evidence comes from the venture capital (VC) ecosystem, where founders and investors have long developed structures that promote shared power and joint decision-making—that is, collaborative rather than competitive structures. More importantly, confrontational theories of the firm neglect that in many public corporations, the insider-shareholder dynamic has also grown increasingly collaborative.

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[19] 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).

As a normative matter, the rise of shareholder collaboration in the public corporation highlights the need for a more complete theory of the firm, one that can explain the circumstances that have led many firms and investors to move from competition to collaboration. We argue that this theory needs to give greater weight to information costs. As observed by Harold Demsetz, although information has obvious connections to moral hazard and agency costs, information costs play a bigger role in the theory of the firm.[20] Changes that have occurred in corporate production and the role of shareholders increase this role. Successful corporations are defined today by the ability to bring together the vast quantities of information that is necessary for the production of "knowledge assets"[21]—ideas linked to investments in technological expertise, product design, market development and organizational capability.[22] 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"[23] has never been more to the point.

The normative task is no longer only to determine the appropriate balance of shareholder and manager power to limit managerial moral hazard. For the shift to a knowledge-rich economy, combined with the rise of a new class of empowered and informed shareholders, makes it likely that *both* firm insiders *and* shareholders possess relevant private information. In other words, what we call "partial information" problems[24] are likely to overlap with, and matter as much as, agency cost problems in the 21st century corporation. Viewed through this lens, the rise of collaboration efficiently responds to the novel need of aggregating the partial information of insiders and shareholders.

A. Traditional Corporate Models

1. The Management-Power Model

The traditional management-power model relies on the board of directors both to centralize decision-making authority and to address the problem of managerial moral hazard.[25] Shareholders

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[20] Harold Demsetz, *The Theory of the Firm Revisited*, 4 J. LAW, 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, e.g.,* 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); MICHAEL POLANYI, PERSONAL KNOWLEDGE: TOWARDS A POST-CRITICAL PHILOSOPHY 52 (1958) (discussing the concept of tacit or personal knowledge—things that we may know but find impossible to completely and effectively communicate to others); LUDWIG VON MISES, HUMAN ACTION: A TREATISE ON ECONOMICS (1949). *See also* Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior and Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 73-76 (2002) (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.

[21] *See* Big Innovation Ctr., The Purposeful Company–Interim Report 5 (2016), http://www.biginnovationcentre.com/media/uploads/pdf/The%20Purposeful%20Company%20Interim%20Report.pdf [hereafter, THE PURPOSEFUL COMPANY REPORT].

[22] Carol A. Corrado & Charles R. Hulten, *How Do You Measure a "Technological Revolution"?*, 100 AM. ECON. REV. (PAPERS & PROC.) 99, 103 (2010).

[23] Demsetz, *supra* note 20, at 157.

[24] *See supra* note 16.

[25] *See, e.g.,* Bainbridge, *supra* note 3, at 560 (describing board's exclusive authority as the board's "undisturbed power of *fiat*"); 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);

specialize in risk-bearing but are not involved in operational issues.[26] Under this view, collective action problems and asymmetric information provide the key economic arguments for granting ultimate control to the board.

From the perspective of intellectual history, this account of corporate governance accurately captures the managerialist era that began at the end of World War II and ended around 1980. The managerialist corporation revolved around corporate insiders brought in to "hire capital from the investor"[27] and enjoying a nonreviewable power of fiat.[28] Shareholders, on the other hand, were dispersed and passive, with few mechanisms to overcome collective action problems, and hence dismissed as mere capital providers.[29] Management power was not seen as unproblematic, even back then. But under the Coasian assumption that the market could not provide an environment conducive to complex production,[30] it was deemed unavoidable.

Since the early 1980s, however, the pure management power model has been substantially diluted due to a variety of developments, including the rise of the hostile takeover, the introduction of incentive compensation and the appearance of independent directors.[31] In particular, the hostile takeover threatened management's insulation from market pressure, demonstrating for the first time the power and transformative potential of shareholders' stock market purchasing power.[32] Nonetheless, commentators continue to defend versions of the management-power model,[33] arguing that the need to protect the board's informational advantage against the potential interference of less-informed investors explains why the law largely excludes shareholder inputs.[34]

2. *The Shareholder-Power Model*

Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 130-31 (1979) (defending board power in the takeover context).

[26] *See* Fama & Jensen, *supra* note 3, at 308.

[27] Bayless Manning, Book Review, 67 YALE L.J. 1477, 1489 (1958).

[28] *See* ADOLPH A. BERLE, THE AMERICAN ECONOMIC REPUBLIC 169 (1963).

[29] *See* Adolf Berle, *Property, Production and Revolution: A Preface to the Revised Edition*, in ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY xxvii, xxxiii (rev'd ed. 1967).

[30] *See* Coase, *supra* note 1, at 392.

[31] *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, 883-84, 896-97, (2002) (describing both the rise of incentive compensation and independent directors as an adaptive response to the managerial-friendly takeover standards set by Delaware courts); 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 (2007) (similarly 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 (1997) (describing the rise of the monitoring board).

[32] William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1520-21 (1989).

[33] *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.").

[34] *See* Stephen M. Bainbridge, *Preserving Director Primacy by Managing Shareholder Interventions*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 231, 234-36 (Hill & Randall S. Thomas eds., 2015); 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, 1777-82 (2006) (illustrating how a traditionalist would defend board power against proposals to increase shareholder power).

The hostile takeover era did not just put an end to the managerialist model but also marked the beginning of 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 distinctive trait of totalitarianism,[35] neoclassicists viewed the firm as a web of contractual relationships among individuals, whose ongoing transactions were efficiently coordinated by the price mechanism.[36]

Jensen and Meckling (J-M) 1976 article, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, is the landmark publication that formalized and directed the change of approach.[37] J-M's principal agent-model reconceptualized managerial moral hazard as an agency cost and re-cast the market for corporate control as the efficient exercise of shareholder contracting to limit this cost. Easterbrook and Fischel's contractual approach then refined the J-M principal-agent model for corporate law, turning what was implicit in that model into a sequence of normative assertions that revolved around a view of shareholders as the primary corporate constituents.[38]

Hostile takeovers ceased in the wake of the economic collapse of 1989 and then failed to restart. In the conventional account, management's successful effort to obtain legal reforms designed to enable anti-takeover measures explains the takeover's demise.[39] These reforms prompted commentators fiercely to debate whether management use of anti-takeover measures was appropriate or whether management should instead remain passive and allow shareholders the freedom to decide whether to accept a hostile bid.[40] The scene was set for the battle between shareholders and managers over corporate control.

That battle intensified in the early 2000s when the shareholder primacy case shifted to a claim for "shareholder empowerment," which has since generated increased consensus. Shareholder empowerment retained the principal-agent model's focus on managerial moral hazard along with an information-efficient account of stock market pricing. But in response to the alleged impairment of the market's operation due to antitakeover barriers, defendants of shareholder empowerment argued that shareholders should be given greater power, including powers that were currently reserved to corporate insiders.[41] In recent years, the claim for shareholder empowerment has become more a reality than an aspiration, mainly due to steady increases in shareholder concentration and activism, and the occurrence of legal changes that have rewarded the efforts of

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[35] DAVID CIEPLEY, LIBERALISM IN THE SHADOW OF TOTALITARIANISM 83-84 (2006).
[36] Armen A. Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, in ECONOMIC FORCES AT WORK 73, 73–74 (Armen A. Alchian ed., 1977)
[37] Jensen & Meckling, *supra* note 7.
[38] *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).
[39] *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.
[40] *See, e.g.,* Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982) (criticizing the use of anti-takeover defenses); Lipton, *supra* note 25, at 130-31 (defending the use of anti-takeover defenses to protect board primacy).
[41] *See* sources cited *supra* at note 4.

shareholder advocates.[42] As put by one commentator, for the first time since the beginning of the battle between shareholders and insiders over corporate power in the late 1970s, this battle has come to favor shareholders rather than directors and managers.[43]

3. 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 confrontational character of both models is apparent in the discourse. The language of combat goes back to the "takeover battles" of the 1970s which featured "white knights," "scorched earth takeover defenses," "poison pills" and "greenmail." [44] Although the conflicts between shareholders and insiders today rarely involve hostile battles for corporate control, the struggle for corporate power has, if possibly, intensified with the rise of the activist investor and, in particular, hedge funds.

Hostile activists have taken the place of corporate raiders, and commentators are as divided on the relative costs and benefits of activism as they once were about hostile takeovers. Proponents of shareholder empowerment praise activists as the champions of the long-dormant shareholder franchise, who help make "managers more focused on maximizing shareholder-value than on self-aggrandizement and lining their own pockets."[45] Defendants of the management-power model, on the contrary, describe activists as short-termist and destructive of corporate value, "billionaire hedgies who are out to make a quick buck, while driving great companies and the economy into a ditch."[46]

The language of combat also persists. A recent 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.'"[47] Similarly, Fortune magazine described Trian's recent activist campaign at DuPont as "War."[48] A letter sent to American CEOs by Blackrock's Larry Fink in 2014 expressed concerns that activists are out to "destroy jobs."[49] And Delaware Supreme Court Chief Justice Leo Strine's recent essay describes activist hedge fund "wolf packs" and asked "Who Bleeds when the Wolves Bite?"[50]

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[42] *See, e.g.,* K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67, 85-86 (2016) (discussing both market and legal changes that have favored shareholder empowerment).

[43] Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1329 (2013) ("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.").

[44] *See, e.g.,* Gilson, supra note 40, at 781.

[45] Michael D. Goldhaber, *Marty Lipton's War on Hedge Fund Activists*, AM. LAW. Mar. 30, 2015, quoting Marc Weingarten of Schulte Roth & Zabel.

[46] *Id.*

[47] Latham & Watkins, Majority Voting for Directors: The Latest Corporate Governance Initiative, M&A Deal Commentary, Dec. 9. 2005, https://www.lw.com/upload/pubContent/_pdf/pub1437_1.pdf.

[48] Stephen Gandel, *DuPont Nearly Lost its War with Activist Nelson Peltz*, FORTUNE, (Jun. 4, 2015), http://fortune.com/2015/06/04/dupont-nelson-peltz-vote/.

[49] *See* William Alden, *Laurence Fink Says Activist Investing Can "Destroy Jobs*," DEALBOOK, Dec. 11, 2014, https://dealbook.nytimes.com/2014/12/11/laurence-fink-says-activist-investing-can-destroy-jobs/ (quoting comments by Mr. Fink at a DealBook conference).

[50] 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, 1908 (2017).

The confrontational approach is likewise reflected in the characterization of the objectives of each model. Today's adherents to the management-power model defend it in terms of the need to protect the corporation from the short-term interests of activist shareholders.[51] And shareholder advocates persevere in their call to increase shareholder power to reduce managerial agency costs.[52] In other words, both sides view the preservation of power as necessary to curb the destructive tendencies of the opposition.

And yet, as we will show below, this competitive characterization not only does not find support in positive law, but also is no longer normatively justified. As explained in section B, the capacious framework of American corporate law has long accommodated collaborative, in addition to competitive, interactions between shareholders and corporate insiders, most notably in the venture-capital context. More importantly, as we then explain in section C, 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.

B. Private Ordering, Collaboration and Venture Capital

Corporate law obviously structures insider and shareholder inputs. It does not, however, dictate the details of this process; those details are left to private ordering. Under private ordering, confrontational outcomes are one possibility. Consistent with adversarial theories of the corporation, confrontational outcomes 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 can often shape a firms' business policy unilaterally.

But under private ordering, a competitive allocation of corporate power is not the sole possibility. For example, one can argue that incentive-based management compensation entails a form of collaboration between insiders and shareholder.[53] On the one hand, this development provided a novel conduit for the exercise of shareholder discipline, one less confrontational than the takeover channel. On the other, it also helped neutralize the unilateral power boards had received from Delaware courts to "just say no" to unsolicited bids,[54] making these bids more attractive to managers. The trend toward more independent boards also entails collaborative elements. As observed by Jeffrey Gordon, independent directors have a comparative advantage over potentially entrenched executive directors with respect to channeling shareholder inputs.[55]

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[51] *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").

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

[53] *See* Kahan & Rock, *supra* note 31, at 884, 896-97 (maintaining that the increased use of incentive compensation was an adaptive response to the managerial-friendly takeover standards set by Delaware courts).

[54] *See Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985) (first upholding management's use of a poison pill to reject a hostile offer).

[55] 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 (2007).

But they are also in the position to credibly "check" these inputs against insider measures of firm prospects,[56] serving as a "buffer" that can make shareholder discipline less likely.[57]

The clearest evidence against the conclusion that the insider-shareholder relationship is necessarily confrontational comes from the venture capital (VC) ecosystem. In the VC context, founders and investors routinely bargain for collaborative structures that promote shared power and joint decision-making, rather than competing for unilateral decision-making power.[58] 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 initial projection.[59] Two collaborative features are inherent in staged financing. First, staged financing necessarily presupposes an ongoing relationship between the investors and the entrepreneur, one that involves regular rather than sporadic communications, as well as periodic consultation.[60] Indeed, only through frequent interactive exchanges with the entrepreneur can VC investors acquire the information needed to successfully employ stage financing as a means to minimize their investment risk.[61] 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.[62]

The explicit provision of joint decision-making rights is also typical of the VC context. For example, VC contracts frequently provide for the allocation to VC investors of control and monitoring rights that are disproportionate to their equity share.[63] VC investors also usually enjoy

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[56] *Id*. at 1471.

[57] *Id. See also* Gregory H. Shill, The Independent Board as Shield (unpublished manuscript) (explaining how the independent board can serve as a shield that increases managerial power by limiting judicial scrutiny of decisions overseen by such a board).

[58] *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"); D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERG. BUS. L. 133, 139 (1998) (describing the relationship between VC investors and entrepreneurs as a "cooperative relationship."); 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.").

[59] *See, e.g.,* Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOKLYN L. REV. 1163, 1169-1170 (2013) (describing staged financing in VC firms); Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. Rev. 37, 52-53 (2006) (same).

[60] In the jargon of economists, stage financing presupposes a relational contract, that is, an agreement characterized by continuing interactive exchanges between the contracting parties. *See infra* notes --- and accompanying tex.

[61] *See, e.g.,* Bartlett, *supra* note 59, at 52; Utset, *supra* note 20, at 65.

[62] *See* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 330-31 (2005). Typically, control stays in the hands of the entrepreneur when the firm is a "good" state of nature and transferring control to the VC investor in a "bad" state of nature. Importantly, as compared to the unilateral allocation of control power to either the entrepreneur or the investor, this allocation of power avoids that the entrepreneur may seek to continue a business when exit is optimal, while also avoiding that an investor may too quickly move to abandon a business. *See id.*

[63] *See, e.g.,* Bartlett, supra note 59 at 53-54 ("A VC investor . . . [will] negotiate[e] control and monitoring rights that are disproportionate to its stock ownership.").

veto powers over fundamental corporate decisions, so that the undertaking of crucial actions in the development of a start-up business tends to require the consensus of *both* the entrepreneur *and* the investors.[64]

VC contracts also routinely feature the appointment of constituency directors.[65] Constituency directors are directors whose election to the board is traceable to an identified corporate constituency. In the VC context, constituency directors typically represent the VC investors.[66] Although the fiduciary duty implications of constituency directors are debated in the literature, [67] their appointment is designed to facilitate joint-decision making over unilateral decision-making, allowing investors to engage with the entrepreneur in the context of a deliberate process.[68]

Under the influence of agency cost theory, the scholarship on VC contracting has traditionally regarded the above arrangements as the means VC investors employ to reduce the risk of entrepreneurial moral hazard.[69] Therefore, even in the VC context, the prevailing analytical framework has adhered to a confrontational paradigm. As observed by Gordon Smith, however, the relationship between the VC investors and the entrepreneur does not fit the paradigm of a "pure agency relationship, but rather [involves] a more complex interaction characterized by give-and-take on both sides."[70] In a pure agency relationship, the principal's only obligation is providing pecuniary compensation for the agent's services. Venture capitalists, however, tend to provide more than just capital. 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."[71]

These value-added services point to a more complex informational structure of the investors-entrepreneur relationship than that conceptualized under the traditional principal-agent framework. 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. Rather intuitively, a collaborative governance

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[64] *Id.* at 54 ("A VC investor will commonly have veto rights over the issuance of securities, asset sales, mergers, or other important corporate transactions").
[65] *See* Steven N. Kaplan & Per Stromberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003) (empirically analyzing board composition in VC contracts); 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). See also Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461 (2010) (discussing the use of third-party independent directors in start-up firms).
[66] *See* Fried & Ganor, *supra* note 65, at 988 (observing that the link between a constituency director and the VC investors may be more or less explicit).
[67] Simone Sepe, *Intruders in the Boardroom: The Case of Constituency Directors,* 91 WASH. U. L. REV. 309, 342-351 (2013) (discussing the relevant case law).
[68] *See id.* at 335-341 (arguing that constituency directors offer a way to complete the necessary incomplete contracts of venture capitalists and other investors).
[69] Smith, *supra* note 58 at 140.
[70] *Id.* at 139.
[71] *See id.* at 140 (quoting Michael Gorman & William A. Sahlman, *What Do Venture Capitalists Do?*, 4 J. BUS. VENTURING 231 (1989)).

model is better situated than a confrontational one to promote conditions that can facilitate the exploitation of both these sets of information and resources.

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

C. The Rise of Collaboration in the Public Corporation

1. Empowered and Informed Investors

Under the traditional theories of the corporation shareholders essentially provide two inputs: capital and discipline. From this perspective, the main difference between the management-power model and the shareholder-power model is that the former emphasizes the shareholders' role as capital providers, while the latter focuses on the shareholders' role as discipline providers. Neither model, however, acknowledges the radical changes that have occurred in today's corporations on the informational front, changes under which public investors have increasingly come to resemble VC investors, thus providing value-added knowledge on top of capital and discipline.

Modern shareholders no longer fit Berle and Means' account.[72] They have instead become empowered, largely because of the reconcentration of equity ownership,[73] which has continued to increase since the 1990s.[74] Institutional investors now own over two-third of the outstanding shares of the thousand largest U.S. public companies.[75] Notably, institutional investors vary in their characteristics. They include passive mutual funds, which do not "pick" stocks but instead invest across the broad market. But they also include 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 in addition to empowered.

Similar to VC investors, today's institutional investors bring their knowledge of the market rather than just capital to firms, most often concerning corporate governance and strategic planning. Hedge funds, in particular, have developed a reputation as "governance entrepreneurs," which specialize in monitoring and providing both governance and strategic inputs to the firms they target.[76] Although the effect of these inputs, and more generally hedge fund activism, is

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[72] Ronald J. Gilson & Jeffrey Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 868-73 (2013).
[73] Other crucial changes occurred in the market place include the emergence of proxy advisory firms, the adoption of "universal" majority voting and accompanying withhold campaigns. *See* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 995-1005, 1010-11 (2010).
[74] *Id*. at 996.
[75] Gilson & Gordon, *supra* note 72, at 865.
[76] *See id.* at 897.

widely debated,[77] everybody agrees that hedge funds are informed investors. In selecting targets and devising future investment strategies, they 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. [78] Hedge funds also tend to specialize on certain industries or sectors of an industry, around which they build a strong expertise and develop network contacts.[79]

Large institutional investors are also increasingly engaged in information production and no longer just as "reticent" supporters of initiatives undertaken by activist hedge funds.[80] Asset managers like BlackRock, Vanguard, and State Street—whose combined holdings make them the largest shareholder in 40 percent of all U.S. listed companies[81]—now make regular contact with firm insiders. This is called shareholder "engagement." Although some commentators have questioned the extent to which some institutional investors act as informed investors,[82] others document the extensive efforts that large mutual funds such as Vanguard and Blackrock have devoted to developing governance sophistication and expertise.[83] Many large institutional investors now have in-house governance teams that are dedicated to gathering firm-specific governance information and investment insights, rather than relying on the mediated governance services of proxy advisory firms.[84]

Collectively, these developments have considerably weakened the management-power argument that shareholders are poorly informed and should thus play a limited role in corporate decision-making. At the same time, they also challenge the shareholder-power view that shareholders' essential value-added service is disciplining managers. While monitoring remains an essential shareholder input, today's shareholders also provide crucial *informational* inputs, inputs that, as we explain below, the modern independent board may be unable to provide.

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[77] *See* K.J. Martijn Cremers, Saura Masconale & Simone M. Sepe, *Activist Hedge Funds and the Corporation*, 94 WASH. U. L. REV. 261, 270-85 (2017) (summarizing the theoretical and empirical debate on the effects of hedge funds).

[78] *See* OWEN WALKER, BARBARIANS IN THE BOARDROOM 31 (2016).

[79] *See id.*, at 11-21 (discussing the different business models of major hedge fund players).

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

[81] 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 percent. *See* 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. 238, 313 (2017). 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.* 302-306. 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 percent of all assets under management in passive equity funds. *Id.* at 304.

[82] *See, e.g.,* Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, J. CORP. L. (forthcoming 2018) (arguing that passive investors are rationally ignorant and calling for the elimination of their right to vote their shares but arguing that active fund managers are informed due to the research incidental to their investment decisions).

[83] *See* Jill E. Fisch, Assaf Hamdani and Steven Davidoff Solomon, Passive Investors (working paper 2018) (on file with authors).

[84] As reported by Blackrock, these teams participate "in thousands of conversations with companies each year," conversations that build on the new amount and access to information on which large institutional investors can now count. Blackrock - Viewpoint, *Exploring ESG: A Practitioner's Perspective* 2 (Jun. 2016), https://www.blackrock.com/corporate/en-gb/literature/whitepaper/viewpoint-exploring-esg-a practitionersperspective-june-2016.pdf (last visited Oct. 12, 2017).

2. *The Role of Independent Directors*

The percentage of independent directors on corporate boards has steadily increased since the aftermath of the takeover era,[85] as a result of various mechanisms that have transformed the independent or "monitoring" board into a virtually mandatory element of law.[86] In fact, most U.S. boards are now largely comprised of outsiders with full-time jobs elsewhere and who can devote only limited time to the running of the business for which they act as directors.[87] The outpouring of new regulation that the financial crises of the last decade have brought about also claims a significant portion of that time, at the expense of the time independent directors can spend on information gathering and business decision-making.[88]

Further, the standards for independence have become increasingly stringent over the years, so much so that they would "rule[] out just about anybody who has firsthand knowledge of the company and its industry."[89] While this conclusion might be a tad dramatic, the emphasis placed on independence requirements in current rules governing the board appointment process does sacrifice expertise requirements. The result is that most independent directors lack the firm-specific human capital, knowledge and skills of executive directors and tend instead to be "generalists."[90] In the best-case scenario, independent directors only develop firm-specific expertise over a lengthy process.[91] In the worst-case scenario, they never "develop … more than a rudimentary understanding of their companies' workings." [92]

Some commentators take the radical view that these factors place most directors at an informational disadvantage.[93] We do not share this view; the insider position of independent directors still provides them with access to private firm information that outside investors necessarily lack. Nevertheless, the argument that a firm's directors have a clear informational advantage vis-à-vis outside investors has lost much of its force. Although a board of directors retains access to unique firm-specific information, it seems factually obsolete to assume that the board cannot benefit from the different information that today's empowered shareholders may bring.

3. *Partial Information Problems and Shareholder Collaboration*

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[85] *See* Gordon, *supra* note 55, at 1465 (noting that between 1950 and 2005, the percentage of independent directors increased from approximately 20 percent to 75 percent).

[86] 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 1990 and then in the aftermath of the corporate scandals of the early 200s. *Id.* at 1468, 1477.

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

[88] *Id.*

[89] COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD 45 (2004).

[90] Bainbridge & Henderson, *supra* note 87, at 1066.

[91] CARTER & LORSCH *supra* note 89, at 49.

[92] *Id.* at 45.

[93] *See* Bainbridge & Henderson, *supra* note 87, at 1065-66.

Corporate production has undergone a vast transformation in the last thirty to forty years.[94] 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 knowhow, patents, research and development projects, brand names, and trade secrets.[95] Along the same lines, human capital has also become a specialized resource.[96] 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 driver to success across industries.[97] Moreover, generating and exploiting knowledge demands that knowledge be continually replenished.

As a result, the informational structure of the public corporation has become much more complex than it is reflected in the traditional models of the corporation. Under those models, information issues only matter in connection to moral hazard and other agency costs, because agency costs constitute the primary obstacle to maximizing corporate productivity. The normative task then is to determine the appropriate balance of shareholder and manager power to limit management self-dealing without sacrificing efficient operational decision making. A presumption about the competitive nature of the insider-shareholder relationship logically follows.

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. Partial information problems arise because in a world of increasingly complex investments, no single individual or organization can possess the relevant information to respond effectively to *all* business challenges.[98] 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

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[94] *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)).

[95] 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.

[96] *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).

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

[98] The Purposeful Company Report, *supra* note 21, at 14.

knowledge, knowledge that board members – and especially independent directors – may not necessarily share.

Under these different informational assumptions, the normative necessity of a competitive corporate paradigm disappears. The task is no longer only to determine the appropriate balance of shareholder and manager power to limit managerial moral hazard. Rather, it also involves a determination of 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.

Yet shareholder collaboration remains largely under-analyzed in the corporate law scholarship. This Article is a first attempt at filling the gap. It does so by providing, next, a taxonomy of the forms of collaboration that we increasingly observe in corporate practice. It then analytically explains how collaboration promotes the optimal aggregation of the partial information of insiders and shareholders.

II. SHAREHOLDER COLLABORATION: A TAXONOMY

As seen in Part I, 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.

Large institutional investors collaborate in ways that scale across multiple companies and broad collaborative themes, including executive compensation structures and, more generally, corporate governance arrangements, public policy issues, and regulatory matters. Hedge funds, instead, tend to engage in firm-specific operational collaboration through the proposal of business strategy initiatives and often the appointment of one or more activist directors to supervise the implementation of those initiatives.

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.[99]

This Part examines the spectrum of collaboration, reviewing and categorizing different forms of collaboration and offering some recent anecdotal examples of shareholder collaboration.

A. Large Institutional Investors

1. Shareholder Engagement

[99] A binary choice is one where the alternatives are yes or no, acceptance or decline. A continuous choice, instead, is one between a set of differently preferred alternatives. *See*, *e.g.*, THOMAS SCHELLING, MICRO MOTIVES AND MACRO BEHAVIOR 213-14 (1978); Robert Putnam, *Diplomacy and Domestic Policy: The Logic of Two-Levels Game*, 488

Collaboration between large institutional investors and corporate insiders primarily occurs through shareholder "engagement,"[100] under which investors interact directly with the corporation in general, and the board of directors in particular.[101] Engagement can take a wide range of forms, from private "one-on-one" meetings,[102] to periodic "investor days,"[103] investor relations contacts,[104] industry conference presentations,[105] and a variety of online communication tools.[106] Several companies have 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.[107] Along similar lines, some boards have established "engagement committees," which are permanently charged with managing the shareholder engagement process.[108]

Regardless of its form, engagement involves a collaborative, rather than disciplinary, interaction between corporate insiders and shareholders. Engagement focuses primarily on communication[109]—the provision of shareholder informational inputs to corporate insiders and the provision by insiders to shareholders of their business and governance strategy on issues such as long-term growth, executive compensation, capital allocation, board composition, managerial

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[100] 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 (2016).

[101] Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?,* 2013 U. Ill. L. Rev. 821, 822. See also PWC, The governance divide - Boards and investors in a shifting world, PwC's 2017 Annual Corporate Directors Survey 14, https://www.pwc.com/us/en/governance-insights-center/annual-corporate-directors-survey/assets/pwc-2017-annual-corporate--directors--survey.pdf (last visited May 18, 2018).

[102] PWC, Director-Shareholder Engagement: The New Imperatives 2, https://www.pwc.com/us/en/governance-insights-center/publications/assets/pwc-director-shareholder-engagement-the-new-imperative.pdf (last visited May. 12, 2018).

[103] *Id. at* 3.

[104] Marco Tonello et. al, *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.

[105] *Id.*

[106] *Id. See also* Nasdaq, What's New in Shareholder Engagement: Telling Your Own Story, June 22, 2017, https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=4&ved=2ahUKEwiMvdbG76TcAhXqlFQKHaZnBYAQFjADegQIARAC&url=https%3A%2F%2Flistingcenter.nasdaq.com%2FViewPDF.aspx%3FClearinghouseArticle.aspx%3Fmtrlid%3D1392%26print%3DY%26FileNm%3DWhat%2527s%2520New%2520in%2520Shareholder%2520Engagement%3A%2520Telling%2520Your%2520Own%2520Story&usg=AOvVaw2_E0ZT0hV7oNTgbYnQkhRy (describing shareholder engagement through online interactive proxy statements).

[107] *See, e.g.,* Chapman & Cutler LLP, Considering a Shareholder Engagement Policy – the What, Why and How, Corp. Gov. Quart. Update, 2016, https://www.chapman.com/media/publication/689_Chapman_Considering_Shareholder_Engagement_Policy_092916.pdf (last visited June 1, 2018).

[108] Foley & Lardner LLP, Shareholder Engagement and Proxy Access 9, Nov. 10, 2016, https://www.foley.com/files/Event/4449fde8-09bd-47a9-8d5e-c463796c5fb0/Presentation/EventAttachment/30453ad6-b45f-4bff-8d77-9b90b877de8d/3-C.pdf (last visited Jun. 1, 2018).

[109] The SEC has expressly indicated its support for increased communication between issuers and shareholders and "guidance on ways to enhance the ability of corporations to effectively and efficiently communicate with shareholders." Fairfax, *supra* note 101 at 831.

performance, shareholder proposals, and risk management.[110] The result is a dialogical process about matters of concern.[111]

But shareholder collaboration also goes beyond mere communication. A substantial proportion of large institutional investors are committed investors in the sense that they do not or cannot readily sell their stock if they disagree with managers' operational decisions.[112] 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.[113]

Further, engagement is not just of an advisory nature. Instead, it often results in changes at the involved companies, although these changes are the result of a consensus process between corporate insiders and institutional investors. For example, in a recent survey on the top successful engagement outcomes, shareholders have 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.[114]

Attesting to the mounting importance of shareholder engagement, a recent survey found that 63 percent of large institutional investors have engaged in direct discussions with management over the past five years, and 45 percent had private discussions with a company's board outside of management presence.[115] And while just six percent of S&P 500 companies reported investor engagement as recently as 2010, engagement figures rose to 23 percent by 2012, 50 percent in 2014, and reached 72 percent as of June 2017.[116] 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.[117]

2. *Corporate Governance Vehicles*

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[110] *See* PWC, Director-shareholder engagement: getting it right 2, https://www.pwc.com/us/en/governance-insights-center/publications/assets/pwc-director-shareholder-engagement-getting-it-right.pdf (last visited Jul. 20, 2018).

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

[112] *See* Fisch, et al., *supra* note 83 (explaining that so-called passive investors cannot exit by selling their stock).

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

[114] *See* Foley & Lardner LLP, *supra* note 108.

[115] Joseph McCahery, Zacharias Sautner & Laura Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2906 (2016).

[116] Ernst & Young, *2017 Proxy Season Review*, http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-review/$File/ey-2017-proxy-season-review.pdf (last visited Oct. 9, 2017). Among others, a company's responsiveness to shareholder requests for engagement has also become one of the fundamental evaluation criterion 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. *See* Foley & Lardner LLP, *supra* note 108, at 5.

[117] *See* Fichtner et al., *supra* note 81, at 318. Further, both companies now have dedicated governance teams that are responsible for shareholder engagement.

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 board-shareholder collaboration on a variety of issues and, in particular, corporate governance matters.

One of the first such initiatives was the "Shareholder-Director Exchange Program" (SDX), a private organization established in 2014 by representatives of major U.S. corporations and big institutional investors like BlackRock and Vanguard.[118] 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.[119] 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."[120] That is, each party's willingness to collaborate with the other is seen as crucial within the SDX framework.[121]

Along similar lines, in 2016, representatives of major U.S. corporations and major investors (including again Blackrock, Vanguard and activist hedge fund ValueAct) signed a paper calling for new commonsense principle of corporate governance, principles that build on a constructive dialogue among the involved parties.[122] Among other specific 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.[123]

The "Investor Stewardship Group" (ISG), which was launched in 2017 and brings together a collective of US-based institutional investors and global asset managers,[124] also aims to improve cooperation among companies, large investors, and shareholders.[125] The ISG plans to achieve this goal by providing a first, "unprecedent attempt to establish a set of elementary corporate governance principles for U.S. listed companies as well as parallel stewardship principles for U.S.

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[118] James Woolery, Introduction to the SDX Protocol, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 5, 2014), https://corpgov.law.harvard.edu/2014/02/05/introduction-to-the-sdx-protocol/; *see also* SDX, The Shareholder--Director Exchange, Introduction and Protocol, Feb. 2018, http://www.sdxprotocol.com/wp-content/uploads/2015/04/SDX_Introduction-and-Protocol.pdf (explaining rationale for and setting forth a 10-point protocol offering issuers and shareholders guidance on when to engage and how to make those engagements valuable).

[119] 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/. 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." *See id.*

[120] *Id.*

[121] 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." *See id.*

[122] Tim Armour et al., Commonsense Corporate Governance Principles, COMMONSENSE CORP. GOVERNANCE PRINCIPLES, http://www.governanceprinciples.org [http://perma.cc/YWN6-48PR] (emphasis added).

[123] *See id.*

[124] *See* Investor Stewardship Group, About, https://www.isgframework.org (last visited on Oct. 28, 2017).

[125] *See* David A. Katz, Common-Sense Capitalism, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jul. 28, 2017), https://corpgov.law.harvard.edu/2017/07/28/common-sense-capitalism/; *see also* John C. Wilcox & Morrow Sodali, The Investor Stewardship Group: An Inflection Point in U.S. Corporate?, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 30, 2017) (noticing the closeness of intents of the ISG principles and the Commonsense Principles of Corporate Governance).

institutional investors."[126] The ISG governance principles, in particular, rely on a "comply-or-explain" approach, which is intended to provide companies with the necessary flexibility to adopt a tailored, collaborative response, rather than relying on a prescriptive, confrontational approach.[127]

Along similar lines, in early 2017, the International Business Council of the World Economic Forum approved "The New Paradigm," a programmatic framework that "conceives of corporate governance as a collaboration among corporations, shareholders and other stakeholders…."[128] In particular, under The New Paradigm, institutional investors are expected to "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."[129] In exchange, boards of directors are expected to embrace The New Paradigm's "core principle of good governance and, in seeking to cultivate relationships with investors, will demonstrate that they have engaged …".[130] "In sum, the New Paradigm "recognizes the power of institutional investors to influence corporations,"[131] while demanding that investor power be exercised collaboratively rather than competitively.

3. Policy and Regulatory Issues

Investors' common ownership – the fact that many institutional investors own "significant stakes in multiple firms in the same industry"[132] – also enhances their incentives to collaborate with corporate insiders. It does so by reducing the cost to investors of acquiring information that may be of value to several of their portfolio companies, giving investors a comparative advantage relative to firm management in acquiring this information - an advantage that investors increasingly choose to use *with*, rather than *against*, management.

In particular, common ownership enables institutional investors to acquire and transmit information of macroeconomic trends, evolving legal risks and developing market norms. An example is the recent efforts by several large institutional investors to work with their portfolio companies to promote increased attention to sustainability issues. For example, 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.[133]

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[126] 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/.

[127] ISG members have already declared their intention to utilize this approach in evaluating the governance regimes at their portfolio companies, inform their engagement priorities and potentially factor compliance with the principles into their voting decisions. *See id.*

[128] Martin Lipton, *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth* 1, Sept. 2, 2016, http://www.wlrk.com/docs/thenewparadigm.pdf.

[129] *Id.*

[130] *Id.* at 6.

[131] *Id.* at 7.

[132] Asaf Eckstein, The Upside of Common Ownership in Corporate Law 1, unpublished manuscript (2017).

[133] *See, e.g.,* Steven Mufson, *Financial Firms Lead Shareholder Rebellion against Exxon Mobil Climate Change Policies*, WASH. POST (May 31, 2017).

Finally, 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 pre-proposal stage and to engage in a dialogue with policymakers.[134] 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 requires firms to collaboratively adapt their operational policies.

B. Hedge Funds

1. Constructivist Activism

Activist hedge funds are usually portrayed as the prototypical corporate adversaries. And 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.[135] For example, activists like Nelson Peltz (Trian Fund), Ralph Whitworth (Relational Investor Fund) and Jeffrey Ubben (Value Act) are known for embracing a more "constructivist," longer-term kind of activism.[136]

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.[137]

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.[138] Commentators suggest that collaborative engagement could dominate hostile engagement in the future.[139] In an article published in February 2018, the Financial Times has even spoken of a new class of "sons of activists," which includes several former portfolio managers of more established, hostile hedge funds.[140] This new generation of activists is "eschewing the public dispute and open confrontation" of the older guard and is instead

[134] *See* Eckstein, *supra* note 132.
[135] *See* WALKER, *supra* note 78, at 31.
[136] *See id.* at 13-14, 15-17.
[137] Strine, *supra* note 50, at 1908.
[138] *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, 309-10 (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 12, at 1254, 1261-64 (describing a "dynamic" of "boards and activists . . . edging unmistakably towards collaboration" and providing anecdotal evidence supporting this conclusion).
[139] *See, e.g.,* WALKER, *supra* note 78, at 230.
[140] Lindsay Fortado, *Investing: Activism Enters the Mainstream*, FIN. TIMES, Feb. 14, 2018, https://www.ft.com/content/e04547b8-0d0b-11e8-839d-41ca06376bf2.

"eager to work with management behind the scenes and to hold positions for longer."[141]

The prospects for collaborative activism are further enhanced by the gatekeeping role performed by passive institutional investors. 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.[142] In recent years, however, institutional investors have taken a more nuanced view of activist interventions.[143] On the one hand, they have increasingly withhold support of activists who primarily seek to force companies into share buybacks, extraordinary distributions and other short-term "cut and run" strategies,[144] 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. 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."[145]

2. Settlement Agreements and Activist Directors

Adding to the evidence pointing to a new constructivist trend in hedge fund activism are two central features of today's activism: the exponential increase in both settlement agreements between activists and corporate insiders and the appointment of activist directors. Indeed, the vast majority of activist campaigns, even those that begin as adversarial, end not with a victory for either side but instead with a truce in which firm insiders and activists agree to reciprocal concessions.[146] These concessions typically take the form of a settlement (or "standstill") agreement, under which the target company accepts the addition of activists' representatives to the board in exchange for the activist calling off its hostile campaign. The number of activist representatives serving as directors continues to grow – activists have won 616 board seats since 2013.[147] 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

[141] *Id.*
[142] Gilson & Gordon, *supra* note 72, at 867, 889.
[143] *See* Sepe, *supra* note 5, at 1440-41.
[144] *See* Sorkin, *supra* note 10 (discussing the concerns expressed by Larry Fink, the CEO of BlackRock, about short-termist hedge fund activism).
[145] *See* Matt Turner, *Here is the Letter the World's Largest Investor, BlackRock CEO Larry Fink, Just Sent to CEOs Everywhere*, BUSINESS INSIDER (Feb. 2, 2016), http://www.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-2 (quoting Larry Fink's letter).
[146] *See* WALKER, *supra* note 78, at 36 (reporting that 45.5 percent of US activist campaigns ended in a "truce" between 2010 and 2015); Lucian Bebchuk et al., Dancing with the Activists 4, (unpublished manuscript) (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2948869 (documenting evidence of a threefold increase in standstill agreements from the time period 2000-2002 to 2009-2011); John C. Coffee, Jr., The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality 9 (unpublished manuscript) (Oct. 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3058319 (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).
[147] Jim Rossman, Lazard's 1Q 2018 Activism Review, Harv. Law Sch. Forumon Corp. Gov. & Fin. Reg., Apr. 20, 2018, https://corpgov.law.harvard.edu/2018/04/20/lazards-1q-2018-activism-review

outside the proxy contest process.[148]

Corporate law scholars tend to view settlement agreements and the appointment of activist directors through the same polarized lens as activism itself: either these agreements make incumbent directors subservient to the short-termist activist agenda[149] or, conversely, they are an "intermediary step" to implementing the beneficial disciplinary outcomes sought by activists.[150] We take a more nuanced position. We acknowledge that in some circumstances settlement agreements might resemble more an "unconditional surrender" than a truce, such as when the activists bargain for exclusive private payments[151] or standstill provisions of short duration (for example, less than a year), while contextually providing for some increase in immediate returns to investors.[152] However, like activist interventions more generally, standstill agreements come in many forms and increasingly contemplate a long-term engagement between incumbent directors and activist nominees.[153] Although board representation may still simply be a means to exploring a sale or other structural changes, more activist directors are retaining their board seats for multiple years[154] and focusing their attention on business strategy, management selection and other operational issues.[155] 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, seeking to effect changes in a collaborative rather than confrontational manner.[156]

C. The Spectrum of Collaboration

While shareholder collaboration in the public corporation is a rapidly growing reality, we do not claim that collaboration is universal. Nor we claim that all firms and investors collaborate in

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[148] Lazard's Shareholder Advisory Group, 2017 Activism Year in Review, at 5, https://www.lazard.com/media/450414/lazards-review-of-shareholder-activism-q4-2017pdf.pdf. (reporting that 64% of board seats won by activists in 2017 occurred outside the proxy process).

[149] *See, e.g.*, Coffee, *supra* note 146, at 4, 13-14 (arguing that settlement agreements produce conflicts along the following dimensions: private benefits, information leakage, thwarted majorities, and public morality). Some commentators have also expressed the opposite concern that standstill agreement may be exploited by boards as a means to "hand cuff" activists. *See* Derek D. Bork, Settlement Agreements with Activist Investors – The Latest Entrenchment Device?, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jul. 7, 2016).

[150] *See, e.g.*, Bebchuk et al., *supra* note 146, at 4 (arguing that settlement agreements provide an efficient response to issues of incomplete contracting arising in the activist hedge fund context).

[151] *See* Coffee, *supra* note 146, at 15-17 (stating that the payments can take subtle forms, also they tend to be rare).

[152] State Street has taken the lead among big institutional investors to point out features of settlement agreements that are especially alarming, including both short duration of the agreements and short shareholding periods by the activists. *See id* at 24.

[153] 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. *See* Bork, *supra* note 149.

[154] *See, e.g.*, Ian D. Gow, Sa-Pyung Sean Shin & Suraj Srinivasanm, Activist Directors: Determinants and Consequences, working paper (2014) (reporting average tenure, as of 2013, of two years for activist directors who had left board and nearly four years for directors who are still on the board).

[155] *See id.* at 9 (documenting percentage of activist campaigns in 2017 devoted to various objectives). *See also* Ethan Klingsberg & Elizabeth Bieber, *Activism in 2018*, HARV. L. SCH. FOR. ON CORP. GOV. & SEC. REG., Jan. 29, 2018 (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.").

[156] Ira Millstein makes a convincing case for constructive activism in his recent book. *See* Ira Millstein, THE ACTIVIST DIRECTOR: LESSONS FROM THE BOARDROOM AND THE FUTURE OF THE CORPORATION (2016).

the same way. Although both shareholder engagement and constructivist activism – two of the most important forms of collaboration – seem to be progressively developing a structural, systemic character, each firm's engagement presents unique features and so does each activist campaign. The current collaborative spectrum is also in continuous evolution and includes several options such as (i) inside v. outside collaboration, (ii) binding v. non-binding collaboration (depending on whether the deliberative outcome involves collective obligations that cannot be broken), and (iii) contractual v. relational collaboration. Further, these alternatives are cumulative rather than exclusive, meaning that several combinations between each alternative are possible.

For example, the appointment to the board of an "activist" director can be conceptualized as a form of "non-binding within" collaboration, where collaboration takes place within the organizational structure of the corporation but does not involve any predetermined obligations. Ad-hoc board committees responsible for shareholder relations (such as engagement committees) are also a possibility within the category of "non-binding within" collaboration, although one that departs less from the traditional board-centric model. Investor participation on internal committees or discretionary procedures for director or CEO selection is closer to a form of "binding within" collaboration,[157] especially if the investor participation is accompanied by veto powers (similar to what occurs in the VC context).[158] On the opposite end of the spectrum, "non-binding outside" collaboration can range from the participation to existing governance vehicles, such as the SDX or ISG,[159] to the organization of investor days, informal meetings and conversations, and the like.

Another important distinction is that between contractual and relational collaboration. In some cases, insider and shareholders contractualize the collaborative process (or part of it), such as when they conclude a standstill agreement. View through this lens, standstill agreements can be seen as a contract-based collaborative alternative to hostile hedge fund activism, an alternative that can produce both binding and non-binding outcomes. The empirical evidence suggests that "shareholder agreements" between activist investors of all types[160] (not just hedge funds) and insiders also are on the rise.[161] While highly idiosyncratic, shareholder agreements have larger scope than standstill agreements: they specify rights and duties for both firm insiders and shareholders on issues such as private information access, director and management appointments, buy and sell restrictions and strategic alliances.[162] These contracts are also more frequent in firms that have more intangible assets and are younger and less profitable,[163] again very similar to what happens in the VC context.

[157] At least one corporation has established an advisory committee to allow shareholders to suggest new directors. *See Dangerous Talk? When/How Should Directors Communicate with Shareholders*?, LATHAM & WATKINS (Latham & Watkins, San Diego, C.A.), at 2. Recently, 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. *See* Coffee, *supra* note 146, at 26.
[158] *See supra* notes --- and accompanying text.
[159] *See supra* notes --- and accompanying text.
[160] *See* Jordan Schoenfeld, Shareholder Manager Contracting in Public Companies, (unpublished manuscript at 2) (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3046182. These investors included banks, broker dealers, companies/corporations, employee benefit plans, endowment funds, holding companies, insurance companies, investment advisers, investment companies, partnerships, religious organizations, and savings associations.
[161] In 2015 alone, there were 335 such agreements. *Id.*
[162] *Id.* at 13-27.
[163] *Id.* at 5-6, 27-34.

In most cases, however, collaboration is governed by relational and implicit contracts, rather than explicit ones. Relational contracts[164] are agreements characterized by continuing highly interactive exchanges between the contracting parties and which last over time.[165] The relationship between boards and major institutional investors can accurately be described as ongoing and involving regular rather than sporadic communications, as well as periodic consultations. Similarly, once a standstill agreement (or another shareholder agreement) is executed, a board's relationship with activists also tends to become ongoing.[166]

The choice between contractual and relational collaboration matters not only formally but may reflect tradeoffs between more stable and flexible "coalitions." A deliberative mode that promotes the stability of the "coalition" between insiders and shareholders reduces the likelihood of a breach of the collaborative agreement. Thus, collaboration that is operationalized through an explicit contract (such as a standstill agreement or other shareholder agreements) makes a breach less likely. On the other hand, collaboration that hinges more on the direct exchange of the parties and less on institutional or contractual procedures is likely to enable a swifter decision-making process, which may prove vital uncertain or changing environments.

The bottom line is that collaboration is a unique process and there is no one "right" (or better) way to collaborate. Instead, as illustrated in the next section, different collaborative patterns at different firms can reflect the needs and objectives of those firms and their investors.

D. Anecdotal Evidence

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."[167] Only eight days later, on September 8, 2017, Scott Stringer, the NYC 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

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[164] MacNeil was the first to put forth the importance of the principle of solidarity and reciprocity in the study of (relational) contracts. *See* Ian R. MacNeil, *The Many Futures of Contract*, 47 S. CAL. L. REV. 691, 694-97, (1974); Ian R. MacNeil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 856-57, 862, 895 (1978). For a more recent formalized treatment of relational contracts, *see e.g.*, Jonathan Levin, *Relational Incentive Contracts*, 93 AM. ECON. REV. 835 (2003); Jonathan Levin, *Multilateral Contracting and the Employment Relationship*, QUART. J. ECON. 1075, 1077 (2002).

[165] Another way to think of relational contracts is by contraposition: relational contracts share none of the features of discrete contracts, which are characterized by short duration, limited personal interaction, precise measurement of the objects of exchange, and requirement of only a minimum, if any, of cooperation between the parties. Karen Eggleston et al., *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91, 119-20 (2000).

[166] *See* Coffee, *supra* note 146, at 10 (stating that in 2016, a "ten well-known activists won 76 seats," out of 131 overall disputed seats on the boards of directors of targeted companies).

[167] Martin Lipton, Wachtell, Lipton, Rosen & Katz, Perspectives on Today's Letter from Vanguard (Aug. 31, 2017), available at http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.25729.17.pdf.

director criteria, diversity and skillsets and their linkage to the company's needs and risks.[168] In June 2018, T. Rowe Price, a major institutional investor, issued a statement emphasizing the importance of being able to "cultivate constructive, private, two-way communications" with company management teams.[169] Investors are also increasingly encouraging issuers to develop structures to facilitate an ongoing collaborative enterprise. For example, Vanguard CEO Bill McNabb has called for firms to establish "shareholder liaison committees,"[170] such as the one formed by Tempur Sealy in 2015.[171]

Anecdotal evidence of collaborative hedge fund activism is also increasing. Value Act's involvement with Microsoft offers a high-profile example.[172] In 2013, Value Act researched Microsoft for months, concluding that the company suffered from a "perception problem." Most investors believed that the company's profits came largely from the sale of operating systems and personal computers. The declining PC market thus suggested that Microsoft's prospects were not good. Value Act instead believed the company's strength lay in other services, such as the company's Office suite of products and Outlook email system.

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

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

> battles, victors, and losers. It is 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.[173]

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[168] Martin Lipton & Sebastian Niles, Wachtell, Lipton, Rosen & Katz, Institutional Investor Input into Director Selection (Sept. 8, 2017) (on file with authors).

[169] T. Rowe Price, T. Rowe Price's Investment Philosophy on Shareholder Activism, June 2018, http://www.wlrk.com/docs/trowepriceesgspotlightjune2018.pdf.

[170] *See* Letter dated Feb. 27, 2015 from F. William McNabb III, Vanguard's Chairman and CEO, https://about.vanguard.com/investment-stewardship/CEO_Letter_03_02_ext.pdf (explaining that "such a committee can provide an appropriate structure for communicating with significant shareholders").

[171] Press Release, *Tempur Sealy Announces Leadership and Board Changes*, May 11, 2015, http://investor.tempursealy.com/releasedetail.cfm?ReleaseID=912242 (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.").

[172] WALKER, *supra* note 78, at 145-55.

[173] *Id.* at 155.

Value Act's investment in Microsoft was a long-term one. Mason continued to sit on the Microsoft board and Value Act to hold a substantial quantity of Microsoft stock through 2017.[174] During this period of time, Microsoft's stock price continued to increase.

The 94-page whitepaper released by Nelson Peltz's Trian Fund in the recent engagement at Procter & Gamble (P&G)[175] provides another relevant example. Specifically, Trian's whitepaper made it clear that the fund was seeking the addition of Peltz to the P&G board in order to create "sustainable long-term value at P&G," and not seeking to replace the P&G CEO or any other "classic" disciplinary outcomes sought by hostile activists.[176] 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.[177] Concededly the P&G board strongly opposed Trian's intervention, which led to one of the most expensive proxy contests in history.[178] In the end, however, P&G shareholders narrowly supported Peltz's candidacy.[179] 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 "working collaboratively with [P&G's CEO] and the rest of the board to drive sustainable long-term shareholder value."[180]

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.[181] That Trian had knowledge unavailable to GE seems implicit in that request. At the same time, such a request would arguably not have materialized if, as noted by one commentator, 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."[182]

Lastly, on the front of the new generation of the "sons of activists," up and coming De Shaw & Co. made news in early 2018 for gaining three boards seats at Lowe's, the giant home

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[174] ValueAct Capital Reduces Microsoft Stake, Market Folly, (Aug. 9, 2017), http://www.marketfolly.com/2017/08/valueact-capital-reduces-microsoft-stake.html.

[175] Trian Partners, Revitalize P&G Together, Vote the White Proxy Card, http://www.wlrk.com/docs/Trian-PG-White-Paper-9_6_17.pdf (last visited September 12, 2017).

[176] 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/.

[177] *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/ (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.").

[178] 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 (describing the contest as "the most expensive proxy fight in U.S. history).

[179] *See, e.g.,* 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 (reporting that Peltz won by fewer than 43,000 shares).

[180] Id.

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

[182] 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/.

improvement chain.[183] The appointment of De Shaw's activist directors took place after a settlement that Lowe's management described as involving "constructive discussions" with the fund.[184] Significantly, the entire campaign was kept private until the settlement. According to industry watchers, this circumstance underlines the change in approach of the new generation of activists, which are "not just less confrontational in public, but also easier to work with behind the scenes."[185] Whereas the older guard would pressure, or even intimidate incumbents into effecting desired changes, the new guard is "not going to intimidate anyone."[186] Instead, they are trying to collaborate with insiders.

III. DEFENDING AND STRUCTURING THE COLLABORATIVE MODEL

Part I 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 the rise of 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. Part II then offered a first taxonomy of the new collaborative patterns that are taking place between investors and corporate insiders.

In this Part, we use insights from both epistemic models of collective wisdom and game theory to explain analytically how collaboration promotes the optimal aggregation of partial information, defending the normative desirability of the collaborative model. We do this through the following steps. In Section 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 Section 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 Section C, we offer an illustration to make the value-increasing properties of shareholder collaboration more tangible. Lastly, in Section 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. Why Collaboration is Normatively Attractively

1. Information Complementarity

We claim that the value of collaboration flows from the aggregation of the partial information that insiders and shareholders are likely to possess in a world of complex investments and reconcentrated equity ownership. But what exactly is the source of this added value?

The answer turns on the insight that the partial information supplied by collaborating investors

[183] Fortado, *supra* note 140.
[184] *Id.*
[185] *Id.*
[186] *Id.*

and corporate 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.[187] 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.[188] Information that is relatively similar thus tends to be substitute, as a second piece of information can be expected not to add much knowledge when it is similar to information that we already possess.

Cognitive models help explain why the aggregate knowledge of today's insiders and shareholders is likely to be more about complementary than substitute information and hence why collaborative decision-making that aggregate this information adds value to many firms. These models distinguish between *interpretative* signals and the standard *generated* signals of statistical collective-wisdom models.[189] "Generated" signals are the result of a random variable drawn from a distribution. For example, in the corporate context, observed sales of a new product sends a generated signal about whether the product is of good quality.[190] Generated signals, however, cannot capture the fact that agents do not just receive signals, but 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. The importance of interpreting this signal correctly to make appropriate operational decisions about the future of the product may also induce agents 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" signal. Unlike generated signals, which are passively received by the agents, interpreted signals result from the agents' "active cognitive effort."[191] That is, to create an

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[187] *See* Matthew C. Stephenson, *Information Acquisition and Institutional Design*, 124 HARV. L. REV. 1422, 1467 (2011).
[188] *Id.*
[189] *See* Lu Hong & Scott Page, *Interpreted and Generated Signals*, 144 J. ECON. THEORY 2174, 2175 (2009); Lu Hong & Scott Page, *Some Microfoundations of Collective Wisdom*, in COLLECTIVE WISDOM, PRINCIPLES AND MECHANISMS 56, 58 (2012).
[190] Along the same lines, what the jurors observe at trial produces a generated signal about whether the defendant is guilty or innocent, where each signal is correlated with the variable of interest by a probabilistic relationship. 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.

Hong & Page, *supra* note 189, at 1275.
[191] *Id*. That is, interpreted signals capture the fact that an individual's prediction about an outcome of interest can be thought of as a statistical signal, but this signal will likely depend on how this individual interpret the world. *See* Hong & Page, *supra* note 189, at 57.

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.[192]

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. Cognitive theory show that these models need to be *sophisticated* and *diverse*. 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.[193]

Note the easy compatibility between interpreted signals and complementary information. In the case of interpreted signals, signal heterogeneity (the production of different predictions) stems from cognitive diversity among sophisticated agents rather than randomness (as for generated signals).[194] It follows that information based on interpreted signals is more likely to be complementary, relative to information that is the result of generated signals.

We argue that 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.

Concerning diversity, because of insiders' access to private firm information, their interpretative models can realistically be assumed to be diverse from those employed 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. Further, hedge funds themselves tend to have different business models and exhibit idiosyncratic features, especially when it comes to target selection. Some hedge funds, for example, focus on targeting companies in certain industries, others are governance specialists, and each fund follows a different template in deciding when moving on a company.[195] 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.

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[192] 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. Hong & Page, *supra* note 189, at 57.
[193] More analytically, diverse interpretative models tend to produce negatively correlated predictions and negatively correlated predictions produce better aggregate outcomes. *Id.* at 58.
[194] *See* Hong & Page, *supra* note 189, at 2175.
[195] WALKER, *supra* note 78, at 11-21 (comparing the business models and intervention strategies of the most important U.S. hedge funds).

Therefore, because the information held by today's investors is likely to complement the information held by firm insiders, we conclude that a collaborative decision-making model can aggregate the complementary information possessed by insiders and differently-situated shareholders to increase firm value.

2. Information Aggregation through Markets v. Collaboration

If board-shareholder collaboration can generate and aggregate complementary information, increasing firm value, how should that collaboration be structured? There are two possibilities.

The first is collaboration through the mediation of markets, with prices serving as a focal point for shareholder inputs. This is the form of collaboration that operates in Gordon's model where markets convey shareholder information to independent directors.[196] Under this model, the board—more particularly, for Gordon, the independent director—uses the information provided by prices about shareholder inputs collaboratively for optimal decision-making, evaluating that information against its own private information about the corporate affairs.

Notably, 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.[197] Under Hayek's epistemic version of Adam Smith's invisible hand,[198] the price system thus provides a form of mediated interaction between insiders and shareholders, which can be relied upon to aggregate their respective information.[199] To the extent that prices provide a sufficient mechanism to aggregate relevant information, direct collaboration would seem to be unnecessary.[200]

The second possibility is that of a direct deliberative process between boards and shareholders, similar to what typically happens in legislative bodies.[201] Deliberation allows agents to convey their interpreted signals directly rather than having those signals mediated through prices. For example, on a rainy day, deliberation would allow an agent to convey to other agents the message:

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[196] *See supra* text accompanying notes __ through __.

[197] *See* Frederick A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).

[198] *See* Adrian Vermeule, *Many-Minds Arguments in Legal Theory*, 1 J. LEGAL ANALYSIS 1, 7 (2009).

[199] One could argue, however, that because this view relies on trading as transmission mechanism, markets may aggregate shareholder information effectively, but cannot 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 transmission mechanism, as both disclosure and trading serve to convey the agent's information.

[200] It is worth emphasizing the difference between the confrontational use to which market-based information is put under the shareholder-power model and the collaborative use of market-based information considered here. In that model, market-based information is basically employed to exclude insider information, which is dismissed as "cheap talking." On the contrary, the collaborative use of market-based information does not exclude insider information. Rather, as explained by Gordon, it serves to aggregate insiders and investor information, allowing the board—more particularly, for Gordon, the independent director—to use that information collaboratively for optimal decision-making. *See Gordon*, *supra* note 55.

[201] *See* John Gastil & James P. Dillard, *Increasing Political Sophistication through Public Deliberation*, 16 POL. COMMUNICATION 3, 5 (1999).

"Today, the weather is bad." Conversely, the transmission of this information through markets would occur by observing that the price of umbrellas increased.

We argue that the rise of collaborative patterns between corporate insiders and investors results from the fact that deliberation is a superior mechanism for the aggregation of partial and complementary information. There are two reasons. First, markets may temporarily fail to aggregate information efficiently. This does not imply that there is no value in market-based information. Over time, prices converge to fundamental values.[202] But the potential gap between prices and fundamental values reduces 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.[203]

Second, asset pricing theory teaches that when securities are "non-separable," information in competitive markets with partially informed traders does not get aggregated at all.[204] A security is "separable" when traders have substitute information. Recall that substitute information is sufficiently similar information, so that a trader does not need other traders' information to make better 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. While the two sets of information are different, they both provide a proxy on the company's future productivity. Hence the information is substitute, and the securities held by the investors are separable.[205] This implies that neither trader can increase the accuracy of her prediction about the company's value by using the other trader's information. Each trader will thus trade based on her own information, which will then be incorporated in the company's stock price as predicted by the Hayekian model.

A security is instead "non-separable" when information is complementary, that is, when the information of other traders enables each trader to make a more accurate prediction about the value of a project or company. Consider, for example, the case of a computer manufacturer that is ready to launch a new computer. Also assume that there are two investors (traders), where one investor operates on an interpretative model that specializes in hardware products, while the other trader operates on a model that specializes in software products. 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 value of the company's new computer project. Indeed, the success of a computer is likely to depend on both the quality of its hardware and the hardware's compatibility with the software available (or forthcoming) in the market. It follows that without access to the other investor's information, 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.

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[202] Bratton & Sepe, *supra* note 18, at 39.
[203] *Id.*
[204] Michael Ostrovski, *Information Aggregation in Dynamic Markets with Strategic Traders*, 80 ECONOMETRICA 2595, 2596 (2012).
[205] 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 Part III.B, should be intended as providing a stylized illustration of current informational structures.

A deliberative process allows the investors to combine their complementary information about the new computer project, better evaluate such a project and potentially add value to that project through the transmission of relevant knowledge to the board. 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 to multiple states of the world). In contrast, when investors communicate through trading, they can only observe market prices, which are unidimensional objects. Hence, we conclude that deliberation is a better medium than price from an epistemic point of view.

B. The Value of Collaboration: An Illustration

To illustrate how collaboration can effectively aggregate the complementary information of corporate insiders and shareholders in a way that market trading cannot, we provide a hypothetical illustration. Consider a computer manufacturer, which we will call *NewSys* and which is about to launch a new computer. For simplicity, we focus on the relationship between the *Board* of *NewSys* and a single investor, which we will call *RedRock.* Similar to the stylized illustration at the end of Part III.A.2 above, we assume that the *Board* has private information on the hardware produced by *NewSys*, while *RedRock* has private information on the software that is available on the market,[206] so that the two information sets are complementary.

Let us also 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 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, which occurrence is equiprobable (i.e., each state materializes with probability ¼). 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*' 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.

[206] Note that the *Board* may also have information on available market software, but not the same information as *RedRock*.

Therefore, *Newsys*' computer project will be valuable under *State A* and *D*, but not in *State B* and *C*. To capture this, assume that each *NewSys* stock has value equal to $200 under *State A* and *D*, and zero under *State 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, the *Board* receives a signal (based on its private information) about the true state of the world before this state becomes common knowledge (that is, before *NewSys* computer is actually sold in the market). 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, assume that *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*; therefore the state of the world will be either *B* or *D* with the same probability.

Under this information structure, the expected value of the computer project as reflected in *NewSys* stock will be $100 for both the *Board* and *RedRock*.[207] Indeed, if the *Board* receives the signal a_1 (under which the state of the world can be either *A* or *B* with the same probability), the expected value of *NewSys* stock to the *Board* will be ½ × ($200) + ½ × (0) = $100.[208] 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* will also be $100.[209] 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 transacting behavior of the other. As seen, *RedRock* will only be willing to trade *NewSys* stock up to $100 (whether she receives the signal r_1 or r_2). Under this price signal (i.e., reflecting that the expected value of the new computer for *RedRock* is $100), the *Board* will not be able to update its beliefs about the computer project, which the *Board* also values at $100 based on its own information (regardless of whether she receives the signal a_1 or a_2). 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* can be expected to underinvest in the

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[207] 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] × ($200) + [*Prob* (B)| a_1] × (0) = $100, where, by the Bayes' Rule, *Prob* (A)| a_1 = [*Prob* (a_1|A) × *Prob* (A)]\[*Prob* (a)] = (½ × ¼)/(½) = ½ as *Prob* (a_1) = *Prob* (A) + *Prob* (B) = ½. Please note that 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 defined similarly and each is 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.

[208] This is a rational expectation equilibrium. Rational expectations theory studies the manner in which economic agents exploit available information to form their expectations. *See generally* Lars Ljungqvist & Thomas J. Sargent, RECURSIVE MACROECONOMIC THEORY 186 (2d ed. 2000)

[209] ½ × ($200) + ½ × (0) = $100.

computer project relative to a scenario where it had knowledge that the true state is, for example, *State A* and thus the real value of the computer is $200.

Conversely, consider 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* would then be mutually informed that the only state which 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 upon the occurrence of *State B* or any other case of un-matched technology (i.e., *State C*).[210] On the other hand, under reciprocal signals that are 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). [211]

C. Structures to Make Collaboration Incentive-Compatible

The preceding discussion has shown that collaboration is socially efficient as it adds 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 game theory to identify what structures can help ensure that both corporate insiders and investors have the right individual incentives to collaborate.

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[210] The idea that shareholder engagement might reduce corporate expenditures in wasteful research and development, leading to lower but more efficient spending is consistent with the empirical findings of Alon Brav et al. *See* Alon Brav, Wei Jiang, Song Ma, & Xuan Tian, *How Does Hedge Fund Activism Reshape Corporate Innovation?,* __ J. FIN. ECON. __ (forthcoming), https://ssrn.com/abstract=2409404 (reporting that issuers targeted by activist hedge funds reduce R&D spending but increase innovation output).

[211] For completeness, we also consider here 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). In this case, since *RedRock* has perfect information on the true state, while the *Board* only has partial information, the security is separable as *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 stocks of *NewSys*, as it knows that *NewSys*' fundamental value is $200. There results that *RedRock*'s trading will drive up the share price. In particular, *RedRock* will be willing to buy *NewSys* shares at a price above $100 and will continue to do so 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 a (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 does efficiently aggregate information. Note, however, that the efficient aggregation of information that obtains with separable securities does not solve other asset pricing imperfections. Even when securities are separable, the problem persists of when the relevant information will be aggregated. Indeed, sophisticated investors with short-term business models may have distortionary incentives, including incentives not to immediately reveal their information through prices due to speculative reasons. Of course, 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, 539-40 (2012) (formally showing that in a dynamic market, rational investors can find it profitable to speculate on short-term price differentials).

How should the gains from collaboration be split between insiders and shareholders to ensure they both have the right incentives to participate in the collaborative process? What say should each party have in this process to preserve the individual efficiency of collaboration? Answering these and other questions on the governance of collaboration will hopefully provide both a theoretical framework and a normative benchmark for current and future experimentation with the collaborative model of the corporation.

1. Economic Rights

In game theory, a game is defined as "cooperative" when players form coalitions to achieve their goals.[212] More particularly, a coalition is worth forming when two conditions are preliminarily satisfied: that players can do better together than alone (this is the *superadditivity* condition)[213] and larger coalitions are more valuable than smaller ones (this is the *monotonicity* condition).[214] Board-shareholder collaboration satisfies both conditions. First, participatory deliberative mechanisms allow the corporation to capture the added value of insider and shareholder complementary inputs, incorporating incentives for insiders and shareholders to participate as part of a group (and thus satisfying superadditivity).[215] Second, the value added by collaboration naturally increases with the number of investors participating in the deliberative process when information is complementary, so that larger "coalitions" can be assumed to outperform smaller coalitions (and hence to satisfy monotonicity).[216]

Once it is determined that a coalition is worthwhile, game theory teaches that whether a player will decide to take part in it depends on the player's expected gains from the cooperative game. In order for a coalition to be formed, these gains need to be at least equivalent to what the player would receive by playing individually outside the coalition.[217] This raises the question of how the value of the coalition should be divided among the coalition's members, that is, the question of a coalition's *economic rights*. In the corporate context, the nature of the players is such that multiple economic rights are involved. First, collaboration between insiders and shareholders poses the question of how the value added from collaboration should be divided between the corporation (that is, the shareholders at large as represented by the board) and the group of investors participating in the deliberative process (the engaged shareholders). Second, there are the economic rights of *each* engaged shareholder. Indeed, taking part in the deliberative process may

[212] More technically, a cooperative solution involves a stable set of outcomes such that it meets two conditions: "(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." *See* PAUL WEIRICH, COLLECTIVE RATIONALITY 152 (2009).
[213] *See* MICHAEL MASCHLER ET AL., GAME THEORY 671 (2103).
[214] *See id.* at 660.
[215] *See supra* note 213 and accompanying text.
[216] There is a caveat, however. If on the one hand the shift to re-concentrated equity ownership has enabled the implementation of participatory deliberative mechanisms; on the other hand, under this shift a limited number of intermediary institutions now control the great majority of outstanding shares. It follows that the number of investors who possess the incentives and resources to collaborate with insiders is intrinsically limited.
[217] As put by Weirich, "[i]ndividuals are unit-coalitions. So each individual must receive at least as much as she can get on her own. … Whether a coalitional game's outcome gives a coalition at least its value depends on whether it assigns to the coalition's members utilities that sum to at least the coalition's value." WEIRICH, *supra* note 212, at 156.

involve significant research costs[218] which investors will be unwilling to bear unless the share of their individual payoffs from collaboration compensate them for such costs.

We argue that there is a prima facie case that the pro-rata sharing rule that is embodied in the equity security contract efficiently addresses both issues, supporting the view that collaboration is consistent with the existing structure of corporate law. First, under the pro-rata sharing rule each shareholder receives a share of the surplus from collaboration that is proportional to her economic interest in the issuer. This means, in turn, that the deliberative process yields a premium to *all* shareholders, making it *individually* rational for both the board and managers, as representatives of the shareholders at large, and the engaged shareholders to participate in collaboration.

Second, under standard equity-based compensation contracts, which tie executive compensation to equity returns, the pro-rata sharing rule embedded in the equity contract ensures that executives have their own incentives to participate in the collaborative process.

Third, by ensuring that shareholders participate in the value added by collaboration proportionately to the size of their equity stake, the pro-rata sharing rule makes it rational for engaged shareholders to invest in information up to the increase in value for them that this information is expected to produce. That is, in general, the equity contract efficiently provides shareholders with incentives to invest in the production of complementary information proportionally to their economic rights in the corporation.

Fourth, and lastly, the equity security contract reduces (but does not eliminate, as we note below) the concern that insider-shareholder deliberation might be the vehicle through which heavyweight 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.[219] In the corporate context, this risk is unlikely, as the equity contract acts to level the bargaining power of all interested parties in the distribution of the gains arising from deliberation.

2. *Decision-Making Rights*

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

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[218] 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. *See* Nickolay M. Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision* Model, 107 J. FIN. ECON. 610, 612 (2013).

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

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 decisions rights of the collaborative process. We question this conclusion. There are two reasons. First, on the board's side, the one share, one vote rule would require the delegated exercise of voting power from all the non-collaborating investors to the board, raising significant coordination issues. Second, on the investors' side, while the rule would be easier to administer, it could still prove functionally problematic. Indeed, while the acquisition of information by the collaborating investors can be assumed to be largely a function of their equity stakes, the investors' business model (in this Article's terms, the investors' interpretative model) can also play an important role. For example, given the same equity stake, a hedge fund that has a private-equity-like investment policy and only invests in a restricted portfolio of companies (this is the case of Value Act, for example)[220] 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 such as Vanguard.

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.[221] 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. This approach both avoids issues involving the board's role as shareholder-representative and ensures that investors that are more likely to produce complementary information do not end up with less say than investors with a larger stake but a business model that is less likely to produce relevant knowledge. Indeed, 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 corporation, costs that may not be directly proportional to the size of the investor's equity stake.[222]

In practice, the marginal contribution criterion will often entail a presumption that the board is the "player' with the highest marginal contribution or, in the jargon of game theorists, the "veto player," without which the coalition cannot be formed in the first place.[223] As a *descriptive* matter, this presumption is consistent with the substantial authority corporate law grants to the board of directors in managing the corporate affairs.[224] Directors' access, as insiders, to unique firm-

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[220] *See* WALKER, *supra* note 78, at 17.

[221] This is referred to as the "Shapley value" criterion. *See* MASCHLER ET AL., *supra* note 213, at 760-761. 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. *Id.* The Shapley value then accords each player the average of her marginal contributions to the possible efficient joint acts. *Id.*

[222] One could wonder why we do not propose to use the marginal contribution also for economic rights. Our response is that investors could have incentives to overstate their contributions (that is, the value of their complementary information) to capture higher gains. Conversely, when claiming a higher say is not associated to higher gains, parties are less likely to have incentives to overstate their contribution, especially when one considers that a higher say could increase an investor's collaborating costs.

[223] *See* MASCHLER ET AL., *supra* note 213, at 681.

[224] *See* DEL. CODE ANN. tit. 8, § 141(a) (2015); MODEL US. CORP. ACT § 8.01(b) (AM. BAR ASS'N 2010).

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.[225]

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 board (or even just the CEO) is clearly underperforming. This underperformance signals the potential value that investors can add 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.[226] 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 re-conceptualize settlements in which a board voluntarily appoints investors' representatives in a constructive context as a reflection of a relatively higher informational contribution on the investors' part. For example, in the Microsoft case discussed above,[227] the appointment of a Value Act's representative to the board can be seen as a manifestation of the importance that the Value Act'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 more stable forms of within, potentially binding, collaboration, such as the appointment of a board representative or the negotiation of veto powers. Conversely, relatively low contributions are more likely to be organized in the form of "non-binding outside" deliberation, such as informal meetings and the like.

IV. IMPLICATIONS 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 individually efficient for both insiders and collaborating investors. Yet in the real world, things

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[225] 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.

[226] 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. FORUM ON CORP. GOV. & FIN. REG., Jan. 26, 2017, https://corpgov.law.harvard.edu/2017/01/26/dealing-with-activist-hedge-funds-and-other-activist-investors/ (observing that "The activist may approach a company with an extensive high-quality analysis of the company's business that supports the activist's recommendations").

[227] *See supra* text accompanying notes 172-174.

can go wrong. Specifically, insiders and 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 firm value. These risks of opportunism challenge existing principles of corporate law which operate largely from the premise of insider-shareholder confrontation.

In this Part, we identify some of the opportunism risks arising under the collaborative model and highlight the limitations of existing law in addressing these risks. The risks that we identify fall within three basic categories. First, there is the risk that shareholders will gain access to firm-specific information as a result of the collaborative process and will mis-use that information to benefit themselves or to harm the corporation. Second, there is the broader risk that both shareholders and insiders may engage in deviating behaviors by acting to further their private interests, jeopardizing the viability of collaboration or exacerbating conflicts of interest between insiders and shareholders. Third, there is the risk of shareholder-insider collusion that may sacrifice the interests of other shareholders or non-shareholder constituencies. The existing tools to address these concerns — confidentiality agreements and fiduciary duties — are ill-suited for a collaborative context and should be rethought.

A. Mis-use of Information

1. *Shareholders at Large*

Effective collaboration, in some cases, requires that corporate insiders share firm-specific information with investors.[228] This information-sharing can take various forms. Corporate insiders who meet privately with investors may provide those investors with non-public 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 non-public information about the corporation, its operations and business strategy on an ongoing basis.

Perhaps the most obvious concern raised by this information-sharing is that shareholders may use the information that they receive to obtain a trading advantage. A variety of empirical studies report that shareholders who meet privately with insiders can obtain trading advantages.[229] Although these studies focus primarily on private interactions that are specifically 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."[230]

The federal securities laws address the mis-use of firm-specific information in two ways. First, insiders who disclose information to shareholders in circumstances in which that information is

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[228] Shareholders share information with insiders as well, but, as noted in this section, such information-sharing is unlikely to raise analogous concerns.

[229] See, e.g., Jihwon Park & Eugene Soltes. What Do Investors Ask Managers Privately?. working paper at 7 (2017), http://www.shareholderforum.com/access/Library/20171206_Park&Soltes.pdf ("A body of prior academic literature finds that investors who gain access to managers privately make more informed trades").

[230] John C. Coffee, Jr., Robert J. Jackson, Jr., Joshua R. Mitts & Robert E. Bishop, Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board? (available at https://ssrn.com/abstract=3100995) (last updated January 19, 2018). *See also* Coffee, *supra* note 146, at 4 (identifying similar concerns).

likely to be used in securities trading violate Regulation Fair Disclosure (Regulation FD). Regulation FD makes it unlawful for corporations and their agents to provide certain kinds of selective disclosure to shareholders.[231] Second, federal law may impose insider trading liability upon both insiders who tip material non-public information to shareholders and the shareholders that trade on that information.

The disclosure of non-public corporate information raises concerns beyond securities trading, however.[232] Shareholders may mis-use information in other ways.[233] 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 mis-use that was not linked to trading involved Bill Ackman, then a director of J.C. Penney, leaking confidential board information to the press.[234]

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.[235] Ruger's confidentiality policy states that it is expressly motivated, in part, by the need to comply with Regulation FD.[236]

Of course, shareholders do not need to meet privately with insiders in order 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 positions.[237] Moreover, the refusal of corporate insiders to meet privately with shareholders prevents the deliberation that distinguishes shareholder collaboration from other methods of increasing the information available to either corporate insiders or shareholders.

Even when insiders meet privately with shareholders, however, they need not share material non-public information. The SEC guidelines explicitly state that Regulation FD does not prevent

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[231] *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716 (Aug. 24, 2000).

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

[233] 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." *See* Nathan Swem, Information in Financial Markets: Who Gets it First? (2017-02), https://ssrn.com/abstract=2939519.

[234] Priya Cherian Huskins, *Boardroom Confidential: Directors and Their Duty*, Woodruff, Sawyer & Co., (Sept. 13, 2016), https://wsandco.com/do-notebook/boardroom-confidential/.

[235] See, e.g., Statement of Sturm Ruger CEO Christopher John Killoy, transcript of Q1 2018 earnings call May 9, 2018, avail. at Seeking Alpha, https://seekingalpha.com/article/4171931-sturm-ruger-and-co-rgr-q1-2018-results-earnings-call-transcript?part=single ("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"). Also available as exhibit to Sturm, Ruger & Co., 8-K dated May 14, 2018, avail. at https://www.streetinsider.com/dr/news.php?id=14188900

[236] Ruger, Investment Community Communications Policy, 2018, avail. at https://ruger.com/corporate/PDF/InvestorCommunicationPolicy.pdf.

[237] *See, e.g.*, McCahery, et al., *supra* note 115 (reporting survey results in which shareholders report their frequent use of private engagements with management and directors and describe them as very important).

insiders from engaging privately with shareholders and offer procedural suggestions designed to prevent the accidental disclosure of non-public information such as preapproving topics for meeting and ensuring the presence of legal counsel.[238] For some investors, such as mutual funds, meetings that do not involve the dissemination of non-public information by corporate officials are likely to be optimal for both companies and investors. These procedures protect companies from potential securities liability and, importantly, investors, which need to be able to maintain liquidity, do not give up their ability to trade. Private meetings offer insiders access to investor information, which they can then aggregate with firm information, but the aggregation does not necessarily require that firm information be shared with the investors. Indeed, even without disclosing non-public information, private meetings enable insiders to probe investor preferences, explore the reasons for their positions, and provide investors with reasons why their preferences may not be consistent with the company's best interests.

2. Hedge Funds, Activist Directors and Confidentiality Agreements

The situation may be different for hedge funds. Like mutual funds, some hedge funds may prefer to avoid obtaining material non-public information to preserve their ability to trade[239] and may explicitly request that companies not divulge any non-public information in their private meetings. Moreover, not every hedge fund collaboration requires insiders to disclose non-public 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 funds' frequent preparation of extensive business plans and proposals.[240] Nonetheless, some collaborations will 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 a hedge fund representative serves as a director or board observer, he or she necessarily will become privy to material non-public information.

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[238] *See* Regulation FD, SEC (last updated June 4, 2010), http://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm. 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, THE STATE OF ENGAGEMENT BETWEEN U.S. CORPORATIONS AND SHAREHOLDERS: A STUDY CONDUCTED BY INSTITUTIONAL SHAREHOLDER SERVICES FOR THE INVESTOR RESPONSIBILITY RESEARCH CENTER INSTITUTE 20 (2011), available at http://www.irrcinstitute.org/pdf/IRRC-ISS_EngagementStudy.pdf.

[239] 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." Cuban was subsequently charged with insider trading, but a jury determined that he was not liable. See, e.g., Rachelle Younglai & Robert MacMillan, *SEC charges Mark Cuban with insider trading*, Reuters, Dec. 7, 2008, https://www.reuters.com/article/us-sec-markcuban/sec-charges-mark-cuban-with-insider-trading-idUSTRE4AG5IM20081118. Cuban was subsequently charged with insider trading, but a jury determined that he was not liable. Id., Jana J. Pruet, Billionaire Mark Cuban cleared of insider trading; blasts U.S. government, Reuters, Oct. 16, 2013, https://www.reuters.com/article/us-usa-sec-cuban-verdict-idUSBRE99F0ZM20131016.

[240] 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 Viceira, Dhruva Kaul & Peter Lee, Trian Partners and DuPont (A), Harv. Bus. School Case Study, Mar. 20, 2017.

Insiders have cited concerns over the potential for mis-use of information as a basis for limiting the access of activist directors to confidential firm information.[241] Some companies have even responded to the appointment of activist directors by forming executive committees of the board as a way of "walling off" an activist director from information or deliberations.[242] 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.[243] Activist directors are unlikely to collaborate effectively without such access.

A more complex issue concerns the ability of a hedge fund director or representative to share information with others at his or her 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 the activist director to operate most effectively, he or she 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 directors navigate in perilous waters in transmitting information to their sponsors.[244] Overall, however, the relevant case law seems to suggest that activist directors *are permitted* to share firm information with their sponsors.[245] After all, as observed by Justice Travis Laster and Mark Zeberkiewicz, a rule against information sharing would be both unrealistic[246] and potentially detrimental.[247]

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[241] 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.

[242] *See, e.g.*, Christopher P. Skroupa, *Onboarding An Activist-Nominated Director -- Best Practices, Risks And Mistakes To Avoid,* FORBES, Jan. 23, 2018, https://www.forbes.com/sites/christopherskroupa/2018/01/23/onboarding-an-activist-nominated-director-best-practices-risks-mistakes-to-avoid/2/#7ef025197030 (explaining that "The formation of an executive committee effectively walls off the activist investor's nominees from most of the board's deliberations").

[243] *See, e.g., Hall v. Search Capital Group, Inc.,* 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.")

[244] *See* 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, 773-74 (2008); 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).

[245] *See, e.g., Kalisman v. Friedman*, Civ. A. No. 8447-VCL, 2013 WL 1668205, *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."); Schoon v. Smith, 953 A.2d 196, 208-209 (Del. 2008) (implicitly confirming the position that constituency directors can share information with their sponsors).

[246] *See* J. Travis Laster & M. Zeberkiewicz, *The Rights and Duties of Blockholder Directors,* 70 BUS. LAW. 33, 49-53, 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.").

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

The concern that an activist director or fund may mis-use material non-public information can also be addressed through confidentiality agreements, and indeed the use of such agreements is common practice when companies find it beneficial to communicate material non-public information to shareholders.[248] 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.[249] Because the fact and terms of the merger and the subsequent spin-offs were, at the time of these negotiations, non-public and highly market sensitive, Trian participated pursuant to a confidentiality agreement.[250]

A confidentiality agreement largely addresses legal and practical concerns over the potential mis-use of information.[251] The SEC has explicitly stated that confidentiality agreements are an appropriate way for insiders to limit their potential liability exposure under Regulation FD. Similarly, SEC rule 10b-5-2 prohibits anyone who receives material non-public information pursuant to a confidentiality agreement from trading on that information. 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.[252] 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.

We note, however, that confidentiality agreements are an imperfect solution to concerns that insiders will mis-use of corporate information. First, if insiders insist on the use of confidentiality agreements as a prerequisite to engaging with investors, such a policy is likely to chill potentially valuable collaborations. As noted above, many investors have liquidity needs that prevent them

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[248] *See* Schoenfeld, *supra* note 160, at 16 (providing several examples of shareholder agreements granting shareholders access to material non-public information).

[249] See, Dow/DuPont Final Proxy Statement and Prospectus, Background of Merger, June 10, 2016, at 72, https://www.sec.gov/Archives/edgar/data/1666700/000119312516618361/d125888d424b3.htm (describing meetings between DuPont executives and four Trian representatives, pursuant to a non-disclosure 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").

[250] See Mark S. Gerber, *US Corporate Governance: Have We Crossed the Rubicon?,* Skadden's 2016 Insights – Governance, Jan. 2016, https://www.skadden.com/insights/publications/2016/01/us-corporate-governance-brhave-we-crossed-the-rubi (describing Trian's participant pursuant to a confidentiality agreement).

[251] Bishop, 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. Bishop, et al. *supra* note 230.

[252] *See, e.g*., David Katz, Boardroom Confidentiality Under Focus, HARV. L. SCH. FORUM ON CORP. GOV. & FIN. REG., (Jan. 23, 2014), https://corpgov.law.harvard.edu/2014/01/23/boardroom-confidentiality-under-focus/ ("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 241.

to committing to contract terms that limit their ability to trade and will not be willing to 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 mis-use information, they should not be held to a higher standard than insiders. Corporate officials are, for example, free to trade in their company's stock with appropriate safeguards such as a requirement that trades be pre-approved or take place only during specified trading windows.[253] Collaborating investors should also 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.[254] That duty requires all directors, including shareholder-nominated directors, to maintain material company information confidential without the need for a confidentiality agreement.[255] Finally, some commentators have raised the concern that issuers may use confidentiality agreements to "oppress directors,"[256] although such a concern appears more likely when a hedge fund has obtained board seats through confrontation rather than collaboration.

B. Conflicts of Interest

A second concern is that insider or shareholder opportunism may prevent the viability of collaboration, wasting the value that aggregation of insider and shareholder information may add to the corporate venture. Alternatively, collaboration may exacerbate conflicts of interest between insiders and shareholders or create the opportunity for collusion between insiders and shareholders to pursue objectives that are contrary to the interests of other shareholders or stakeholders.

On the shareholder side, the most commonly-cited risk of opportunism is short-termism.[257] Some investors, for example, hedge funds with short-term oriented business models, might be in a position to benefit from short term operational strategies even if those strategies sacrifice long term firm value.[258] A number of commentators have argued that "the short-term strategies of many

[253] Corporate officers and directors are also subject to the short-swing trading limitations of section 16(b). Those restrictions apply equally to activist-nominated directors.
[254] *See* Cyril Moscow, *Director Confidentiality*, 74 LAW & CONTEMP. PROBS. 197 (2011). The duty of confidentiality is part of a director's general duty of loyalty. *See* Sepe, *supra* note 67, at 344. *See also* Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675 (2009); Charles M. Nathan et al., *Maintaining Board Confidentiality*, THE HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 23, 2010, 2:12 PM), http://blogs.law.harvard.edu/corpgov/2010/01/23/maintaining-board-confidentiality.
[255] *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 CORPORATE 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.").
[256] *See* Frost, *supra* note 241 (quoting director Charles Elson).
[257] 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 shareholder and shareholders generally. The question of whether there is such a thing as short-termism that is not corrected by efficient market pricing is a matter of some debate. *See generally* Lawrence H. Summers, *Is Corporate Short-Termism Really a Problem? The Jury's Still Out*, HARV. BUS. REV.. Feb. 16, 2017; J.B. Heaton, *The "Long Term" in Corporate Law*, 72 BUS. LAW. 353, 355 (2017) ("there is virtually no evidence that shareholders ever prefer short-term gains that are smaller than larger (discounted) long-term gains.").
[258] *See, e.g.*, In re PLX Tech. Inc. Stockholders' Litig., No. 9880-VCL, Del. Ch., Sept. 3, 2015, transcript ruling at 27 (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*

activists are frequently at odds" with the investment horizon of other shareholders.[259] 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, other 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.[260] From this Article's perspective, short-termism matters as a deviating behavior that may result in distorted investor incentives *not* to collaborate but rather to competitively exploit short-term speculative options.[261]

Shareholders, however, may have other conflicts, which collaboration may potentially exacerbate. A shareholder may seek to influence a decision at one portfolio company to improve the value of its position at another company.[262] Or shareholders may have what Marcel Kahan and Edward Rock have termed "hedging-related conflicts" when they hold positions in different types or classes of securities[263] or when they hold both long and short positions.[264] 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.[265] For example, some commentators have

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Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law, 50 WAKE FOREST L. REV. 761, 772 (2015) (arguing that activist shareholder "pressure may logically lead to strategies that sacrifice long-term performance for short-term shareholder wealth."); Kai Haakon Liekefett & Lawrence Elbaum, *Think Twice Before Settling with an Activist*, LAW360, Dec. 9, 2016 (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, or efforts to cut costs, including research and development.

[259] See., e.g., Liekefett & Elbaum, supra note 258.

[260] Strine, *supra* note 50.

[261] Short-termism might be understood here as a form of shareholder self-dealing, leading to a conflict between the interests of that shareholder and shareholders generally.

[262] *See, e.g.,* Marcel Kahan & Edward 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. A number of commentators have discussed the Mylan-King merger and Perry's conflict of interest. *See, e.g.,* id., at 1075; 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); Steven Haas, *SEC Resolves Empty Voting Action Involving King-Mylan Merger*, Harv. L. Sch. Forum on Corp. Gov. & Fin. Reg., Aug. 19, 2009, https://corpgov.law.harvard.edu/2009/08/19/sec-resolves-empty-voting-action-involving-king-mylan-merger/.

[263] 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, e.g. Bo J. Howell, Hedge Funds: A New Dimension in Chapter 11 Bankruptcy Proceedings7 DePaul Bus & Comm. L. J. 35, 46 (2008) (observing how such conflicts can create problems when hedge funds serve on a creditors' committee).

[264] Kahan and Rock describe an example involving the planned acquisition of MONY by AXA in 2004. Kahan & Rock, *supra* note 262 at 1073. See also In re MONY Group, Inc. S'holder Litig., 853 A.2d 661, 668 (Del. Ch. 2004) (describing hedge fund conflicts).

[265] See also 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).

criticized large mutual funds for advocating sustainability objectives.[266] The concern has been raised more broadly with respect to agreements by issuers voluntarily to appoint one or more activist designees to the board to settle an activist campaign.[267]

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 non-responsive and non-collaborative. 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.

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.

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. Two papers by Azar, Schmalz and Tecu examining the airline and banking industries respectively, document collusive behavior by institutional industries to reduce competition.[268] The argument in these papers, which focus primarily on mutual funds, is that common ownership creates an incentive for investors to favor anti-competitive behavior to generate monopolistic profits. 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. While the empirical results of the Azar et al. research have been challenged on a variety of bases,[269] the bottom line is that collusion

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[266] 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. Dept. of Labor, Field Assistance Bulletin No. 2018-01, Apr. 23, 2018.

[267] See., e.g., Liekefett & Elbaum, *supra* note 258 (observing that institutional investors "are now troubled that companies may settle with activists without seeking the input of other shareholders."); see also John C. Coffee, The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality (Oct. 24, 2017), https://ssrn.com/abstract=3058319 (charging that these settlement agreements disenfranchise other shareholders that may not support the activist's nominees).

[268] José Azar, Martin C. Schmalz & Isabel Tecu, *Anti-Competitive Effects of Common Ownership*, J. OF FIN. (Forthcoming); José Azar, Sahil Raina & Martin C. Schmalz, *Ultimate Ownership and Bank Competition*, draft dated Jul. 23, 2016, https://ssrn.com/abstract=2710252.

[269] See, e.g., Edward B. Rock & Daniel L. Rubinfeld, Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance (March 1, 2017), https://ssrn.com/abstract=2925855.

between insiders and investors is possible and the novel collaborative patterns that we describe in this article may offer an important vehicle for collusion.

The foregoing list of potential conflicts of interest that insider-investor collaboration may generate or exacerbate is illustrative, not exhaustive. Both the ability of investors to access firm-specific information and their ability to influence firm decision-making increase the potential for problematic conflicts. Importantly, these conflicts pose a particular challenge in the context of the collaborative theory because, under existing corporate law doctrine, the standard legal response to the potential for conflicts of interest is fiduciary duties. As we explain in the next section, however, the role of the collaborating shareholder is in tension with the classic concept of a fiduciary. As a result, shareholder collaboration highlights existing weaknesses in corporate law fiduciary duties.

C. Fiduciary Duties

As noted in the preceding section, corporate law has traditionally relied primary on fiduciary duties to address issues such as conflicts of interest and the mis-use of firm information. In addition, federal law has incorporated insider fiduciary duties as the basis for the duty to disclose or abstain that underlies federal insider trading law.

Fiduciary duties are a reasonable fit for the Berle and Means corporation in which there is a separation of ownership and control and where managers exercise delegated authority to make decisions for the benefit of shareholder-owners. But fiduciary duties are more difficult to apply when a corporate decisionmaker is acting both as agent and principal, as in the case of collaborating shareholders, or when a decisionmaker is acting on behalf of multiple principals with potentially different interests, as in the case of a hedge fund director. We explore both situations in more detail below. Further, the collaborative model raises a third issue with respect to fiduciary duties – the extent to which such duties may require insiders to collaborate with shareholders and whether an insider's failure to do so is legally actionable.

1. Collaborating Shareholders

The problem with using fiduciary duties in the context of collaborative decision-making stems, in part, from the legal concept of a fiduciary. Under corporate law principles that are derived from agency and trust law, a fiduciary is an agent, someone who acts for another's benefit.[270] Fiduciaries owe their beneficiaries duties that include a duty of care and a duty of loyalty. Specifically, the duty of loyalty requires that the fiduciary act unselfishly, which precludes the fiduciary from taking actions that place its interests above the interests of its beneficiary.[271]

Corporate law treats insiders – officers and directors – as fiduciaries and imposes legal restrictions on self-dealing transactions as well as procedures for subjecting transactions in which

[270] *See, e.g*., Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 Iowa J. Corp. L. 239, 240 (2009) (describing fiduciary concept in the corporation and contending that the common law concept of a fiduciary is "little more than a fiction" in corporate law).

[271] As the Delaware Supreme Court has explained, "the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally." *Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993).

an insider has a personal interest to oversight by a disinterested decision-maker such as an independent committee or a shareholder vote. In contrast, corporate law applies fiduciary duties only to controlling shareholders and, even then, only in very limited contexts.[272] For a shareholder to be treated as a fiduciary, the shareholder must both be in a position to exercise control and to do so in a manner that provides the controlling shareholders with a benefit that is distinct from the benefits conferred on shareholders generally.[273] Apart from this context, corporate law defers to shareholders' rights to act in their own self-interest.[274] Corporate law does not impose a duty on shareholders to act unselfishly when they vote, when they sell their shares or otherwise.[275] Multiple reasons support the distinction between shareholders and insiders, including the fact that shareholders, as a general matter, have limited power to influence corporate decisions.[276] It is also, however, based on the reality that shareholders have heterogeneous interests and preferences, and that corporate law is designed to accommodate, not eliminate those differences.[277]

When shareholders collaborate with corporate insiders, however, they are acting simultaneously for their private benefit and for the benefit of the corporation. Moreover, their collaboration is designed to influence corporate decisions. One solution then is to broaden the scope of fiduciary duties to apply when shareholders collaborate with insiders. Iman Anatwabi and Lynn Stout have 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 argue, 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."[278]

The problem with this approach is that it 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 disinterestedness and unselfishness.[279] Allowing shareholders

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[272] *See* Anabtawi & Stout, *supra* note 265 at 1273 ("shareholder fiduciary duties are commonly understood to exist only for controlling shareholders, and even then, principally in the contexts of freeze-outs and closely held companies").

[273] *See id*.

[274] *Id*., at 1257, n.2

[275] *See, e.g., Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling*, 53 A.2d 441, 447 (Del. 1947) ("Generally speaking, a shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow shareholders."); *accord Bershad v. Curtiss-Wright Corp*., 535 A.2d 840, 845 (Del. 1987). Notably, this principle applies even when a controlling shareholder acts in its capacity as shareholder. *See, e.g., Thorpe v. CERBCO, Inc*., 676 A.2d 436, 442 (Del. 1996) (citing Del. Code Ann. tit. 8, § 271 (1996)) (affirming controlling shareholder's right to vote based on own self-interest in a transaction requiring shareholder approval to sell substantially all of a corporation's assets).

[276] *See, e.g., Charlestown Boot & Shoe Co. v. Dunsmore*, 60 N.H. 85 (1880) (holding that corporation could not, through a shareholder vote, limit directors' statutory authority over corporate operations).

[277] For a careful analysis of the various dimensions on which shareholders may have heterogenous interests see Paul Rose, *Common Agency and the Public Corporation*, 63 Vand. L. Rev. 1355, 1370-1380 (2010).

[278] Anabtawi & Stout, *supra* note 265, at 1295. Notably, the authors focus their proposal primarily on activist hedge funds.

[279] 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. Dept. of Labor*,

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 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. As explained above, shareholders can influence firm decision-making through a range of mechanisms, from the introduction of shareholder proposals or participation in corporate governance organizations.[280] 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).[281] 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 & Stout, such a shareholder would be held to a duty of loyalty standard in defending its voting decision.

2. Activist Directors

A second problem arises when activist representatives serve on the board of directors. Indeed, 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[282] and, as noted above, the interests of the activist may differ from those of the corporation or the other shareholders.[283] Constituency directors may be held liable for breaching their fiduciary duty by favoring the interests of one set of shareholders over another.[284] In addition, constituency directors face potential liability exposure for disclosing corporate information to their nominating shareholders.[285]

The problem of constituency directors is not unique to hedge fund collaboration, however. As discussed in Part I, venture capital funds make extensive use of constituency directors to address the potential for competing and conflicting interests in start-up companies. In the VC context, constituency directors are often used by VC investors or creditors precisely because their interests

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885 F.3d 360 (5th Cir. 2018) (invalidating the 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. Aiken, *Mitigating conflicts of interest in compensation*, Inv. News, Oct. 25, 2017, http://www.investmentnews.com/article/20171025/FREE/171029963/mitigating-conflicts-of-interest-in-compensation.

[280] *See also* Rose, *supra* note 277.

[281] Sharon Terlep & David Benoit, *P&G Concedes Proxy Fight, Adds Nelson Peltz to Its Board*, Wall St. J., Dec. 15, 2017, https://www.wsj.com/articles/p-g-concedes-proxy-fight-adds-nelson-peltz-to-its-board-1513377485.

[282] 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, 773-74 (2008).

[283] Sepe, supra note **Error! Bookmark not defined.**. at 341-60 (providing a detailed law and economics discussion of the matter).

[284] *Id.* at 344-45.

[285] *See id*. *See also* David Katz, *Boardroom Confidentiality Under Focus*, Harv. L. Sch. Forum on Corp. Gov. & Fin. Reg., Jan. 23, 2014, https://corpgov.law.harvard.edu/2014/01/23/boardroom-confidentiality-under-focus/ (warning that activist board representatives may breach their fiduciary duties by disclosing confidential board information to their funds).

may differ from those of the common stockholders.[286] Corporate law has struggled, however, with the tension between this divergence of interest and classic fiduciary principles. In *Trados*, for example, the Delaware Chancery Court explicitly held that constituency directors who favored the interests of preferred stockholders over those of common stockholders breached their fiduciary duties.[287] This approach ignores the fundamental premise underlying the use of constituency directors – such directors are intended to protect the interests of the party that nominated them. Thus, as one of us has argued, the principle of party autonomy should operate as a limiting principle to the application of fiduciary principles, and a constituency director should not be viewed as conflicted merely because he or she is acting in the interests of that party.[288]

The *Trados* case illustrates both that horizontal conflicts among shareholders are increasingly common in the modern corporation and that fiduciary duties are a poor tool for dealing with such conflicts.[289] Shareholder collaboration, and shareholder empowerment more generally, increase the potential for horizontal conflicts and extend the environment in which such conflicts arise from the VC company to the public corporation. Although a full analysis of this problem is beyond the scope of this article,[290] we note that structural and contractual solutions offer the potential for providing predictability concerning the rights and obligations of various corporate stakeholders. At a minimum then, courts should consider giving broader deference to the use of mechanisms such as designated board representatives, tailored use of shareholder voting rights such as supermajority provisions or minority veto rights, and contractual limitations on the duty of loyalty as limitations on conventional fiduciary principles.[291]

3. Collaborating Insiders

Finally, the potential for shareholder collaboration to address partial information problems and lead to value-enhancing operational decisions has the potential to impact insider fiduciary duties. Put simply, do the conclusions in this article suggest that officers and directors have a fiduciary duty to collaborate with shareholders, and would their refusal to do so be actionable? A recent example of such a refusal was DuPont former CEO Ellen Kullman's refusal to meet with Trian, to discuss Trian's recommendations, or to agree to put Nelson Peltz on the DuPont board.

We do not believe that our analysis should have a significant impact on the liability exposure of corporate insiders. The decision to collaborate and, if so, how to engage and whether to incorporate a shareholder's information, is a business decision and, as such, subject to the protection of the business judgment rule. So long as insiders are disinterested and act in good faith

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[286] For a straightforward 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).

[287] *In re Trados Inc. S'holder Litig*., No. 1512-CC, 2009 WL 2225958, at *7 (Del Ch. July 24, 2009).

[288] Sepe, *supra* note **Error! Bookmark not defined.** at __.

[289] *Id*. at 367.

[290] We intend to develop the implications of shareholder collaboration for corporate fiduciary duties more thoroughly in future work.

[291] We note that the Delaware legislature endorsed this approach in the context of the corporation opportunity doctrine. *See, e.g*., Gabriel Rauterberg & Eric Talley, *Contracting out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 Colum. L. Rev. 1075 (2017) (describing and empirically analyzing Delaware statutory amendment enabling corporations to opt out of the corporate opportunity doctrine by contract).

and on an informed basis, their decisions about the scope of collaboration should be respected by the courts. The bottom line is that our analysis, while it may demonstrate to corporate insiders how collaboration can be value-enhancing, does not mandate the degree or form that collaboration should take.

CONCLUSION

Both the management-power model and the shareholder-power model—the currently prevailing models of the public corporation—frame the board-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 (directors and managers) and shareholders to reduce the risk of managerial moral hazard.

This Article showed that this competitive characterization no longer (or only partially) reflects the reality of insider-shareholder dynamics, as these dynamics have now turned into increasingly collaborative. In a coherent, if unheralded, effort, insiders and newly empowered shareholders are joining forces to promote deliberative mechanisms based on collaboration rather than competition and coercion. They are doing so through a variety of means: through direct shareholder engagement about matters of concern, the flourishing of private initiatives aimed at introducing shared governance principles, activist interventions oriented to the longer term, the appointment of activist directors and several other forms of "constructivist" activism. Despite these dramatic transformations, corporate law scholars have paid virtually no attention to shareholder collaboration. This Article provided a first attempt at remedying this gap, exploring the positive, normative and policy 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 venture capital context, where founders and investors have long developed collaborative structures to promote joint decision-making and exploit the ability of VC investors to provide value added services. 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 corporation. The result is that in the current information-rich economy, empowered shareholders increasingly resemble VC investors in their ability to provide value-added knowledge on top of capital and discipline.

Under these changes, the normative task is no longer only to determine the appropriate balance of shareholder and manager power to limit managerial moral hazard. Rather, this task involves a determination of 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, adding corporate value.

Policy-wise, the collaborative model has several implications. By enhancing shareholder access to information, collaboration creates the risk that shareholders may misuse that information. Similarly, shareholder influence on operational decision-making challenges current doctrines that

limit the fiduciary obligations of non-controlling shareholders. Finally, both shareholders and insiders may use the collaborative process to engage in collusive behavior or self-dealing. As a result, the growing importance of collaboration requires rethinking and adapting several existing principles of corporate law. This Article begins the task; however, the conclusions it reaches should not be seen as an arrival point; rather, they will hopefully provide a novel starting point for future research on what really matters in corporate governance.