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"DANGEROUS TALK? WHEN/HOW SHOULD DIRECTORS COMMUNICATE WITH SHAREHOLDERS?"

I. A Brief History

1. ***Until lately, few conceived of directors and shareholders meeting directly; the job of communicating with investors traditionally fell on management, and for good reason.***
 - Management supervises day-to-day company operations.
 - A company's spokesperson must have ready access to legal counsel to prevent unwanted disclosures of material nonpublic information, e.g. under Regulation FD.
 - Designating a particular officer as the company's spokesperson allows the company to speak with one voice on most issues.
 - Directors have not viewed shareholder engagement as part of their job.
 - In the past, shareholders have expressed little interest in speaking to directors.
 - Compulsion, through crisis or other acute events (e.g., payouts for failure or backdating options), has driven most recent initiatives to foster dialogue between directors and institutional owners.
2. ***However, recent events and trends have prompted large shareholders to seek greater influence over a board's decision-making processes.***
 - Shareholder activism in general is on the rise. Last year, shareholders proposed a record number of resolutions. Further, certain "hot-button" issues like majority voting have garnered increasing support from investors.
 - Activist shareholders who perceive management as unwilling to act, underperforming, overpaid or secretive and who believe management has turned a deaf ear now increasingly look to directors for answers and action, e.g., by filing a resolution as a "knock on the door."

- In 2002, Sarbanes-Oxley focused the attention of institutional shareholders (and the SEC) on standing committees of the board. Since then, emphasis has shifted from audit committees to compensation committees and now to corporate governance committees, generating interest in direct communication with directors.
3. ***Today, a small but growing number of companies exhibit a willingness to facilitate director-shareholder communication as a way of avoiding acrimony, embarrassment and expense.***
- Companies are taking shareholders' issues more seriously for a number of reasons:
 - (i) The post-Enron era has witnessed tougher anti-fraud and accounting laws, crackdowns on corporate crime and court rulings that have held directors liable in class-action lawsuits.
 - (ii) Boards increasingly perceive corporate governance and, to a lesser extent, environmental concerns as mainstream issues that affect performance, and not simply "fringe nuisance proposals" that surface only at annual meetings.
 - (iii) Faced with greater federal oversight, directors and executives may prefer to cooperate with shareholders rather than wait for additional mandates.
 - (iv) Conversations between directors and institutional investors may cool investor rhetoric, garner goodwill and trust, humanize the parties involved and minimize the use of shareholder resolutions as a means of encouraging dialogue.
 - (v) Directors often wish to avoid the embarrassment and backlash of withhold-vote campaigns (particularly where majority voting is applicable) like Disney or Home Depot, where in 2006 shareholder anger led to large numbers of withheld votes and contributed to the CEO's ouster.
 - **Pfizer** directors met with institutional investors in October to discuss corporate governance policies, including executive compensation. Reports suggest that both sides had more in common than expected, including a sense that quarterly earnings guidance is unimportant for pharmaceutical companies with long R&D cycles.
 - **UnitedHealth Group** created an advisory committee to allow shareholders to suggest new directors. At least one candidate named by investors now sits on the board.
 - **PepsiCo, Xerox, Pfizer, Office Depot** and others have signed onto a broad set of corporate governance guidelines known as the Aspen Principles, which urge greater communication between companies and their shareholders.
 - At least two U.S. companies, **Aflac** and **Verizon**, have already agreed to give their shareholders a non-binding vote on executive pay.
 - Still, there is little evidence to suggest that most boards and shareholders are regularly engaging in sustained two-way dialogue on governance matters.
 - Desirability of, and best practices for, board-shareholder communication have yet to be embraced by Corporate America.
4. ***Likewise, a consensus of opinion has yet to form among commentators with respect to the value and feasibility of director-shareholder communication.***
- Ira Millstein "believe[s] almost every hot button governance issue can be addressed through constructive communication between boards and management with

shareholders," particularly where shareholders have a legitimate stake in the issue. He cites the following:

- (i) *Board composition.* While the board may be best positioned to ensure the right mix of experience, expertise and independence, shareholders can broaden the board's perspective. Candid exchange and voluntary adoption of majority voting may also alleviate shareholders' demands for access.
 - (ii) *Corporate performance disclosures.* The board may wish to consider its role in overseeing how the company communicates material developments and quarterly earnings guidance, rather than leave these matters to management, investment relations and lawyers.
 - (iii) *Executive performance, compensation and succession.* Dialogue with long-term shareholders about executive compensation may broaden the perspective of compensation committees, balance the views of management and lessen the push for a "say on pay" rule.
 - (iv) *Strategic direction.* Companies have an interest in ensuring that shareholders can evaluate whether the corporate direction aligns with the shareholders' investment intent, particularly with respect to (a) long-term strategies with high up-front costs and (b) transactions requiring shareholder approval.
 - (v) *Societal concerns.* A company's posture vis-à-vis climate change and labor relations, for example, bears on its reputation and the perceived integrity of management and the board. Discussion can help both sides determine if proper resolution of such issues lies with the corporation or elsewhere.
- In contrast, Martin Lipton described Pfizer's meeting as an "example of corporate governance run amuck," and has argued against shareholder activism generally:
- (i) Investor activism prevents companies from attracting qualified and dedicated directors, saps directors' willingness to take risks and shifts the board's role from guiding strategy and advising management to ensuring compliance and performing due diligence.
 - (ii) Activist investors put pressure on boards to manage for short-term performance and liquidity events rather than long-term value creation.
 - (iii) Still, Lipton observes that direct contact between directors and institutional investors may forestall shareholder proxy initiatives where the corporation has significant performance or compliance issues.
- While concerns over Reg FD may currently discourage director-shareholder communication, a recent report suggests that Reg FD should not be regarded as a barricade to dialogue.
- (i) Richard Koppes, for example, has suggested that concerns over Reg FD have minimized actual director-shareholder contact. A recent report from Yale's Millstein Center agrees.
 - (ii) Yet the same Millstein report finds that Reg FD does not actually bar director-shareholder dialogue. Various companies have sought legal advice on this issue and have concluded that Reg FD should be viewed as a caution, and not a barricade, to such dialogue.

(iii) Indeed, the Millstein study concludes that the SEC would likely find broad support for a **safe harbor** covering board-shareowner communications. This would lower the cost of seeking customized legal advice and improve dialogue over governance matters.

II. Electronic Shareholder Forums

1. ***One possible way to facilitate director-shareholder discussion may be through the use of Electronic Shareholder Forums (“e-forums”).***
 - Effective as of February 25, 2008, the SEC adopted amendments to the proxy rules designed to encourage the use of e-forums as a less expensive and more effective way to communicate with shareholders.
 - Generally, the amendments state that proxy rules will not apply to certain solicitations made in an e-forum if the solicitation is made more than 60 days prior to the date announced for the next shareholders’ meeting or, if the announcement is less than 60 days prior to the meeting date, not more than two days following the announcement.
 - In addition, a company that operates an e-forum generally will not be liable for statements made by other forum participants if the forum is operated in compliance with state and federal securities laws and the company’s charter and bylaws.
2. ***Benefits of e-forums include reducing the costs of communicating with shareholders, defusing shareholder concerns and demonstrating commitment toward social issues.***
 - Companies that receive a Rule 14a-8 proposal, or that are subject to shareholder criticism on a particular topic, may be able to use a “symposium” type of e-forum as a channel for communicating with investors and defusing situations.
 - Companies under particular scrutiny may find an investor relations benefit to establishing e-forums. E.g., an energy company could position itself as being socially responsible by hosting e-forums on environmental issues.
 - While a poorly managed forum may lead to an inadvertent release of material non-public information that violates Reg FD, the ease of opening up such forums to the public may reduce the risk of running afoul of Reg FD.
3. ***Nevertheless, e-forums pose certain risks that may discourage their widespread use.***
 - Vocal individuals may hijack poorly managed e-forums and launch anti-management tirades, leading to bad publicity and a lack of shareholder participation.
 - Perhaps more troubling, e-forums could improve the ability of hedge funds and activist shareholders to reach other investors and mobilize against companies.
 - Activists could also use e-forums to conduct straw polls on a year-round, 24/7 basis, adding to the Rule 14a-8 regime that management only has to deal with once a year.
 - Some observers believe that the main consequence of using an e-forum will be to provide activist investors with a highly visible, no-risk patina of legitimacy.
 - Eventually, ISS might offer recommendations for polls on e-forums. ISS could view e-forums as a sign of good corporate governance, factoring it into its “CGQ” ratings. Finally, ISS could view failure to adopt measures that receive shareholder support in online polls as justifying a “withhold” recommendation in director elections.

4. *More information about e-forums may be found in the Corporate Governance Commentary published by Latham & Watkins in January 2008 and available on the CDF website.*

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III. Hypothetical Situations

1. "Say on Pay"

Big Company receives a shareholder proposal from a Corporate Governance Activist (e.g., the American Federation of State, County and Municipal Employees, which is very active in pushing 14a-8 "say on pay" proposals) that seeks to implement a non-binding "say on pay" vote as part of Big Company's annual meeting. The proposal provides for an advisory vote "to approve the pay packages of the Named Executive Officers and the related tabular disclosures in the CDA." The board wishes to retain top-flight senior managers who are highly sought after in the industry, but fears that the compensation necessary to keep such talent may be viewed as excessive.

Big Company questions the motivations of the Activist. The company's board also fears that ISS and other proxy advisory firms will soon push for rigid, one-size-fits-all standards regarding executive compensation—the last thing Big Company wants.

Big Company's board is weighing the idea of communicating with investors about executive pay. Big Company hopes that this will lead to the withdrawal of the Institutional Investor's "say on pay" proposal. Should Big Company engage with investors? If so, how?

- Substantively, would most activists concede that "say on pay" is not just about the *amount* of executive pay, but more importantly the pay *structure*? I.e.:
 - Is enough of the pay at risk and dependent on performance?
 - Are performance targets meaningful?
 - Are performance targets set to enhance company business strategy?
 - Is Big Company rightly skeptical about the motivations of the Institutional Investor? Big Company may be concerned that any attempt to implement a "say on pay" regime will be hijacked by ISS and more extreme activists who will postulate prescriptive standards.
 - Will engagement lessen the push for "say on pay," broaden the perspective of the compensation committee and/or balance the views of management?
- Mechanically, if Big Company's board decides to engage with "responsible" investors, is an annual vote on "say on pay" the best way to do so?
 - Or is Pfizer's approach—hosting an annual conference—more workable? What if there is wholesale adoption of this idea with thousands of companies holding annual meetings with investors each fall?
 - Could an e-forum provide another option in this situation? Risks include the following:
 - If poorly managed, the e-forum may be hijacked by vocal individuals and turned into a platform for launching anti-management tirades.

- The e-forum could improve the ability of hedge funds and other activist investors to reach other investors and mobilize against companies.
- The main consequence of using an e-forum may be to provide activist investors with a highly visible, no-risk patina of legitimacy.
- What other models for effective dialogue might work? Invitation-only meetings? One-off responses? Formal or informal shareholder advisory groups on discrete issues?
- If genuine dialogue seems unlikely, are there tactical advantages to meeting with shareholders?
 - Could a meeting prompt a withdrawal of the proposal or deter a withhold-the-vote campaign?
 - Could periodic meetings ease the challenge of managing activists' demands?

2. *"Hedge Fund"*

A large event-driven Hedge Fund files a 13D against Big Company disclosing a 5.1 percent stake. The 13D describes the Hedge Fund's purpose broadly, thus giving the Hedge Fund significant flexibility in its future conduct. Shortly after filing, the Hedge Fund calls Big Company's chairman of the board and other directors and asks for a meeting. Should the board engage with the Hedge Fund? What factors should the board consider before agreeing to talk?

- What is the Hedge Fund's real motivation?
 - While the Hedge Fund may sincerely wish to engage in a conversation about the conduct of Big Company's business or a corporate governance matter, does it have any end-game other than to pressure Big Company to create a liquidity event?
- What could Big Company gain or lose by agreeing to meet?
 - What if Big Company learns that the Hedge Fund is actively soliciting other hedge funds to take a position in Big Company?
 - What if Big Company learns that the Hedge Fund is increasing its position in the company?
- Should Big Company research the Hedge Fund's track record before agreeing to talk?
 - What if Big Company discovers that the Hedge Fund has a history of successfully encouraging liquidity events at most of the companies in which it has previously invested?
 - What if the Hedge Fund's record reveals a more nuanced approach to its investments? E.g., what if the Hedge Fund has sometimes helped its portfolio companies improve their performance and then exited without seeking a liquidity event?
- What if Big Company accepts and implements constructive advice from the Hedge Fund and is rewarded by a significant increase in its stock price? What will the Hedge Fund do next?
- If a genuine dialogue with the Hedge Fund seems unlikely, should Big Company necessarily go hostile and ignore the Hedge Fund?
 - Are there benefits to communicating despite the low probability of avoiding an ultimate demand for a liquidity event?
 - Could the Hedge Fund ever just go away? If so, why would it?