

# The Golden Leash and the Fiduciary Duty of Loyalty

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## ABSTRACT

In recent years, activist hedge funds have been experimenting with a novel practice in corporate governance: offering their candidates for the board of directors millions of dollars in bonus pay through a device known as a “golden leash.” Such arrangements, which are highly controversial, award directors for accomplishing activist objectives. An emerging body of work views the golden leash through the same polarized lens as activism itself: either the leash locks directors in to a self-serving, “short-termist” agenda, or it creates incentives for them to be better advocates for shareholders. This binary framing obscures some of the golden leash’s most promising qualities.

Though novel and associated with shareholder activists, the golden leash belongs to a larger class of well-established, mainstream legal structures that reduce agency costs and increase expertise at individual firms by, paradoxically, tying directors to multiple firms. These structures include corporate governance innovations in two other areas of the capital markets: the venture capital ecosystem and the practice of corporate directors sharing information with outside entities. Like the golden leash, both of these models create overlapping obligations for directors. Yet these arrangements are welcomed by scholars, courts, and firms on the grounds that they improve enterprise value and corporate governance by quietly blending loyalties, notwithstanding the fact that they also make conflicts of interest more likely.

The golden leash thus follows in a coherent, if unheralded, tradition of structures that forge ultraclose bonds between directors and outside shareholders. This Article argues that the risks posed by this blending of duties should be discounted by the availability of mechanisms to manage any conflicts that result and by advantages conferred in capital formation and governance. Properly designed and disclosed, the golden leash can promote not only superior returns but consensus-building, dialogue, and other values important to sound corporate governance.

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## INTRODUCTION

What do we talk about when we talk about “short-termism” in the context of shareholder activism and corporate governance?

This turns out to be a surprisingly contentious question. One group of scholars, sympathetic to boards of directors, regards shareholder activism<sup>1</sup> as a mechanism for hedge funds to exploit their rights as shareholders to wring the company for short-term gain. Such profits are said to come out of the pockets of other shareholders, the company, and, ultimately, the economy as a whole. Another group counters that shareholder-led campaigns for board seats can serve as an important check on underperforming incumbent directors. This activism-friendly contingent questions the logic behind the charge of activist “short-termism” to begin with,<sup>2</sup> since measures that achieve near-term benefits by depleting the corporate treasury reduce the value of the corporation, thus harming the activists themselves along with all the other shareholders. The two camps have been described by a leading Delaware

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1. For purposes of this Article, references to “activism” and its derivations describe efforts by financial investors, principally hedge funds, to generate changes in a company’s governance, capital allocation strategy, or other areas that they deem value-creating. While there is some overlap between the methods of financial activist shareholders and their social and political counterparts, the focus here is on activist shareholders with economic motivations.
  2. This is partly because the term “short-termism,” while in common use, remains poorly articulated. It has been slammed as “imaginary,” and its very theoretical foundations have been called into question. Mark J. Roe, Opinion, *The Imaginary Problem of Corporate Short-Termism*, WALL STREET J. (Aug. 17, 2015, 7:14 PM), <https://www.wsj.com/articles/the-imaginary-problem-of-corporate-short-termism-1439853276>; see also Robert Anderson IV, *The Long and Short of Corporate Governance*, 23 GEO. MASON L. REV. 19, 20 (2015) (contending the concept is “inconsistent with basic principles of mainstream financial economics”); Anne Tucker, *Short-Termism: Should We Have Better Answers to Basic Questions by Now?*, BUS. L. PROF. BLOG (Dec. 2, 2015), [http://lawprofessors.typepad.com/business\\_law/2015/12/short-termism-should-we-have-better-answers-to-basic-questions-by-now-.html](http://lawprofessors.typepad.com/business_law/2015/12/short-termism-should-we-have-better-answers-to-basic-questions-by-now-.html) [<https://perma.cc/DAN4-W9T6>] (noting the elusiveness of a coherent definition of “short-termism”).

judge as “dueling ideological mythologists,”<sup>3</sup> and the divide extends beyond academia<sup>4</sup> into the marketplace<sup>5</sup> and elsewhere in the public realm.<sup>6</sup>

A controversial innovation in director elections—the phenomenon of activists supplementing director pay—has further polarized the debate over activism and short-termism. Such arrangements, known as “golden leashes,” provide candidates nominated by an activist (designated directors<sup>7</sup>) with additional compensation beyond the pay all directors receive from the company for their service on the board. Golden leashes serve a dual purpose: they facilitate the recruitment of high-quality board candidates to run in director elections that are often high-profile and unpleasant, and they operate as a commitment mechanism. In the typical structure, “leashed” candidates receive a retainer

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3. See 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 (2014). Chief Justice Strine is the top jurist in Delaware.
  4. A cross-section of opposing views can be found in numerous articles. See, e.g., Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015); Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637 (2013); William W. Bratton & Michael L. Wachter, *Shareholders and Social Welfare*, 36 SEATTLE U. L. REV. 489 (2013); Brian R. Cheffins, *Did Corporate Governance “Fail” During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1 (2009); Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51 (2011); 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 (2016); J. Travis Laster & John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 BUS. LAW. 33 (2015). Vice Chancellor Laster is a judge on the Delaware Court of Chancery. Bainbridge and Bebchuk are leading advocates of director primacy and shareholders’ rights, respectively.
  5. For example, Laurence Fink, CEO of Blackrock, one of the world’s largest asset managers, has accused activist hedge funds of destabilizing the U.S. economy. See David Benoit & Vipal Monga, *Are Activist Investors Helping or Undermining American Companies?*, WALL STREET J. (Oct. 5, 2015, 1:55 PM), <http://www.wsj.com/articles/activist-investors-helping-or-hindering-1444067712>.
  6. See Roe, *supra* note 2 (noting comments of Republican politicians, pundits, and a Republican member of the Securities and Exchange Commission (SEC) critical of managing companies to maximize their short-term share price); see also Neil King Jr., *Hillary Clinton Is Not the Only Critic of ‘Quarterly Capitalism’*, WALL STREET J. (July 31, 2015, 7:19 AM), <http://blogs.wsj.com/washwire/2015/07/31/hillary-clinton-joins-al-gore-prince-charles-and-etsy-in-criticizing-quarterly-capitalism> (noting similar comments by Hillary Clinton, Prince Charles, and corporate CEOs). This Article focuses on U.S. capital markets and corporate governance. For a discussion of American shareholder activism in a global context, see Yaron Nili, *Missing the Forest for the Trees: A New Approach to Shareholder Activism*, 4 HARV. BUS. L. REV. 157 (2014).
  7. The practice of directors being nominated to the board by a significant shareholder does not go by a single name. Alternative names for the board members include blockholder directors, director designees, and constituency directors.

initially and the potential for millions of dollars in additional incentive pay if they succeed in driving specified outcomes at the company.<sup>8</sup> The leash is normally used to enlist an unaffiliated outsider as a candidate, since designated directors who are principals of the activist hedge fund already share in the profits the fund makes on its investments. The practice is also known more neutrally as “sponsor compensation,” but the phrase “golden leash”—coined by a board chairman resisting a proxy contest—has stuck.<sup>9</sup>

To its critics, the golden leash is aberrant and troubling. Stephen Bainbridge has called the practice “nonsense,” contending that if it “is not [already] illegal, it ought to be.”<sup>10</sup> Another thoughtful commentator, John Coffee, has compared it to bribery and warned that if legitimized, the practice would be used more often “in a broad range of control and proxy fights, with the long-term result being a shift towards greater risk and leverage.”<sup>11</sup> Recent decisions of the Delaware courts, out-of-court writings of prominent Delaware jurists,<sup>12</sup> and a model bylaw proposed by Wachtell, Lipton, Rosen & Katz<sup>13</sup> (the firm of choice

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8. For additional discussion of golden leash arrangements, see, for example, Matthew D. Cain et al., *How Corporate Governance Is Made: The Case of the Golden Leash*, 164 U. PA. L. REV. 649, 651–52 (2016); Yaron Nili, *Servants of Two Masters? The Feigned Hysteria Over Activist-Paid Directors*, 18 U. PA. J. BUS. L. 509 (2016); and Adam Prestidge, *Activist Compensation of Board Nominees and the Middle Ground Response*, 11 HASTINGS BUS. L.J. 307 (2015).
  9. See, e.g., Prestidge, *supra* note 8, at 309. The coining of the term “golden leash” has been attributed to the chair of Agrium Inc.’s board of directors, Victor J. Zaleschuk, during a proxy fight with the Jana Partners activist hedge fund. See Cain et al., *supra* note 8, at 652 n.8. The term has largely been used neutrally by scholars notwithstanding its origins and pejorative connotation.
  10. Stephen Bainbridge, *Can Corporate Directors Take Third Party Pay From Hedge Funds?*, PROFESSORBAINBRIDGE.COM (Apr. 8, 2013, 9:51 PM), <http://www.professorbainbridge.com/professorbainbridge.com/2013/04/can-corporate-directors-take-third-party-pay-from-hedge-funds.html> [https://perma.cc/P97J-DLD3].
  11. John C. Coffee, Jr., *Shareholder Activism and Ethics: Are Shareholder Bonuses Incentives or Bribes?*, CLS BLUE SKY BLOG (Apr. 29, 2013), <http://clsbluesky.law.columbia.edu/2013/04/29/shareholder-activism-and-ethics-are-shareholder-bonuses-incentives-or-bribes> [https://perma.cc/Q4KV-UR7M].
  12. A recent ruling by the Delaware Chancery Court, combined with an article by the presiding judge, has raised the prospect that courts might formally take a position preferring one time horizon to another. See Transcript of Telephonic Ruling on Defendants’ Motions to Dismiss, *In re PLX Tech. Inc. Stockholders Litig.*, No. 9880-VCL (Del. Ch. dismissed Sept. 3, 2015); Laster & Zeberkiewicz, *supra* note 4, at 39. Vice Chancellor Laster’s judicial opinions have been critical of activist methodology generally.
  13. See Martin Lipton et al., *Wachtell Proposes Bylaw to Ward off Threat of Conflicted Directors*, CLS BLUE SKY BLOG (May 10, 2013), <http://clsbluesky.law.columbia.edu/2013/05/10/wachtell-proposes-bylaw-to-ward-off-threat-of-conflicted-directors> [https://perma.cc/E57T-FDAH]. The bylaw was adopted by a few dozen firms, but later rescinded at the overwhelming majority of them. For a detailed study, see Cain et al., *supra* note 8. Scholars have also pushed back, detailing reasons to favor the availability of the golden leash. See, e.g., Scott E. Prince, Note, *Trimming the Hedges: Why the Adoption of Wachtell, Lipton, Rosen and Katz’s Anti-Golden Leash*

for companies resisting activists) have collectively amplified these concerns and raised the prospect of restrictions on the golden leash or its outright prohibition.

This Article argues that the golden leash has the potential to broadly benefit investors, companies, and the capital markets. While a growing body of work posits that the golden leash can enhance shareholder wealth by aligning directors more closely with shareholders,<sup>14</sup> the arrangement also confers a second advantage overlooked to date by the literature. By enabling the recruitment of outside candidates, the golden leash enlarges the pool of designated directors to include highly competent industry experts with no relationship to the fund, and to whom the fund must make its case. Although not its purpose, the golden leash activates a recruitment process that is likely to bring the activist's objectives, tactics, and message closer to mainstream corporate strategy. The larger potential of the arrangement to influence the character of activist engagements depends on its success in economic terms and its perceived legitimacy. It is too early to judge the former, but it has a long way to go before winning acceptance from many academics and influential Delaware judges.

Scholarship favoring the golden leash is part of a larger literature<sup>15</sup> and empirical case<sup>16</sup> supporting activism and questioning the concept of short-termism,

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*Bylaw Is Ill-Advised*, 9 OHIO ST. ENTREPRENEURIAL BUS. L.J. 145 (2014); *see also*, e.g., Cain et al., *supra* note 8; Nili, *supra* note 8.

14. *See*, e.g., Cain et al., *supra* note 8 (presenting an empirical case that certain classes of companies adopting the Wachtell bylaw (which prohibited golden leashes) experienced share price reductions); Nili, *supra* note 8 (contending that golden leashes can enhance shareholder wealth); Prestidge, *supra* note 8; Prince, *supra* note 13. *But see* Bainbridge, *supra* note 10; Coffee, *supra* note 11.
15. A substantial literature documents economic benefits to shareholders of a company targeted by activists. *See*, e.g., Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39 (2012); Bebchuk et al., *supra* note 4; Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (2009); C.N.V. Krishnan et al., *supra* note 4.
16. *See* Frank Partnoy, Opinion, *The Surprising Market Response to Activist Hedge Funds*, WALL STREET J. (Apr. 22, 2015, 7:01 PM), <http://www.wsj.com/articles/the-surprising-market-response-to-activist-hedge-funds-1429743683> ("[T]he performance of companies that are targeted by the top activists, but are not sold, also generally improved. During the first year after a top activist intervened, return on assets grew by 9% and research and development grew by 2.6%."); Joseph Walker, *Concerns Over Valeant Spread to Other Drug Makers*, WALL STREET J. (Nov. 22, 2015, 8:45 PM), <http://www.wsj.com/articles/concerns-over-valeant-spread-to-other-drug-makers-1448240861> (citing evidence that investors' preference for asset allocation towards cash and away from research and development (R&D) is shifting at pharmaceutical companies, with the pendulum now swinging back towards R&D). *But see* YVAN ALLAIRE, INST. FOR GOVERNANCE OF PRIVATE & PUB. ORGS., HEDGE FUND

which one scholar has declared “imaginary.”<sup>17</sup> However, the validity and desirability of the golden leash need not turn on one’s views on activism. The polarized nature of the debate has obscured important conceptual differences that distinguish this particular activist device from the larger phenomenon of shareholder activism.

The golden leash has supercharged the debate around activism because it injects a specific set of salient yet misplaced anxieties around short-termism into a sacred and independent legal doctrine, the duty of loyalty. To borrow from Coffee’s analogy to bribery<sup>18</sup> the concern is not only the substance of the changes favored by activists (i.e., changes directed at the short term) but also the “bribery” part—the agreement that constitutes the leash—because of its potential to compromise a higher obligation. This charge has additional potency in corporate law, where decisions by a board (potentially including those where a golden leash arrangement is in place) can be insulated from most judicial scrutiny by the business judgment rule.<sup>19</sup>

Filtering these concerns through existing doctrinal frameworks reveals their utter manageability. Though it provokes visceral reactions in the context of shareholder activism, the potential for overlapping duties of loyalty is in fact quite banal. In two related areas of corporate law, directors’ duties of loyalty often freely attach to multiple entities: the practices of (1) directors sharing information outside the corporation; and (2) the venture capital (“VC”) ecosystem, where funds appoint directors to the board of a company.<sup>20</sup> In these areas, overlap in

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ACTIVISM: PRELIMINARY RESULTS AND SOME NEW EMPIRICAL EVIDENCE (2015), [http://www.shareholderforum.com/access/Library/20150401\\_Allaire.pdf](http://www.shareholderforum.com/access/Library/20150401_Allaire.pdf) [https://perma.cc/4J99-YT76] (examining companies targeted unsuccessfully by activists and concluding that they have reduced R&D expenditures); Vipal Monga et al., *As Activism Rises, U.S. Firms Spend More on Buybacks Than Factories*, WALL STREET J. (May 26, 2015, 10:30 PM), <http://www.wsj.com/articles/companies-send-more-cash-back-to-shareholders-1432693805>.

17. Roe, *supra* note 2.

18. See *supra* note 11 and accompanying text.

19. See Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004); see also Anderson, *supra* note 2, at 21 (“If different investment horizons have different interests that implicate the duty of loyalty, conflicts of interest would be ubiquitous.”).

20. More prosaically, mutual funds often nominate directors to the board of large public companies. As long-term investors, their interests are often presumed to be aligned with that of their investors and portfolio companies, but this assumption has not been properly interrogated. See generally Gilson & Gordon, *supra* note 15 (observing differences between the incentives of mutual funds, particularly funds pursuing a passive strategy, and their portfolio companies). One leading problem is that mutual funds compete against each other, i.e., other *funds*, which means that different mutual funds that track a common set of companies, like the S&P 500, compete on fees, not the success of the companies in the index. This basic fact of the passive mutual fund business model, rarely discussed in legal circles, weakens the basis for the funds’ presumed alignment with the interests of their investors and companies.

loyalties is not merely tolerated by courts and the market, but also welcomed on the grounds that it promotes capital formation and superior management. Concerns about abuse are kept in check through a range of well-established formal and informal mechanisms, ranging from market norms to regulatory and judicial oversight.

By analogy to adjacent areas of the capital markets where loyalties overlap, this Article situates the golden leash in a vital but underappreciated category of legal structures that reduce agency costs by blending loyalties fluidly.<sup>21</sup> In so doing, it contends that activist-company cooperation should be embraced as a tool for addressing this structural problem inherent in the independent board model. It also notes some opportunities for collusion presented by the golden leash and advocates enhanced disclosure of such arrangements as a way to safeguard shareholder interests.

The Article proceeds in five Parts. First, Part I briefly overviews trends in activism that suggest a convergence in activist and company interests. This convergence challenges the dominant conception of the two sides as adversaries and may suggest greater receptivity to the golden leash. The golden leash has been tried only a few times to date; Part II examines leading examples and situates them in the frame of procedural corporate governance values. Next, Part III presents a critical discussion of law and scholarship analyzing frictions between the golden leash and the fiduciary duties of “leashed” directors. Part IV explores analogies from two similar areas where fiduciaries owe overlapping duties of loyalty: the sharing of information by directors with outside shareholders and the appointment of directors designated by VC funds to the boards of startup companies. In each example, legitimate concerns about loyalty conflicts are mediated by courts, regulators, and law firms through a range of well-established tools. Part V sketches possible enhancements of existing disclosure regulation that would help unlock the potential of the golden leash for procedural corporate governance. The Article then concludes.

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21. Axiomatically, where multiple duties of loyalty exist, they are said to exist independently and simultaneously rather than blending as such. *See Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939). However, an examination of market practice, scholarship, and doctrine shows that these obligations operate less formalistically and more fluidly in reality. *See infra* Parts II–IV.



## I. THE NORMALIZATION OF ACTIVISM

Shareholder activism is surging. By the end of 2015, activist hedge funds had come to manage \$120 billion in investor capital,<sup>22</sup> double the figure from three years prior<sup>23</sup> and ten times the total from 2005.<sup>24</sup> A growing body of evidence suggests that activist interventions improve targets' long-term value as well as their stock price.<sup>25</sup> Once considered a niche strategy only outsiders with sharp elbows were willing to take up, activism has become far more accepted as an investment concept, including by large companies that are themselves the target of activists. A top banker at Morgan Stanley, which typically advises management, has suggested that activism had become a mainstream methodology: "The demonization of activists, when really what they are doing is providing returns to the same pension and endowment plans [as other asset classes], just seems overdone."<sup>26</sup> While the trend should not be overstated, these same institutional asset managers also increasingly vote with activists on governance issues<sup>27</sup> and collaborate more behind the scenes.<sup>28</sup> Activists are also embracing moderation more often.<sup>29</sup>

The dynamic of boards and activists is edging unmistakably towards collaboration. Announced proxy contests, which pit activist board candidates against

22. David Benoit, *Activism's Long Road From Corporate Raiding to Banner Year*, WALL STREET J. (Dec. 26, 2015, 12:01 AM), <http://www.wsj.com/articles/activisms-long-road-from-corporate-raiding-to-banner-year-1451070910>.

23. *Id.*

24. CORP. FIN. ADVISORY & MERGERS & ACQUISITIONS, J.P. MORGAN, THE ACTIVIST REVOLUTION: UNDERSTANDING AND NAVIGATING A NEW WORLD OF HEIGHTENED INVESTOR SCRUTINY 1 (2015) [hereinafter CORP. FIN. ADVISORY], <https://www.jpmorgan.com/jpmpdf/1320693986586.pdf> [<https://perma.cc/BD6F-BJKC>].

25. See, e.g., Bebchuk et al., *supra* note 4. This observation is not uniformly embraced. See, e.g., Bratton & Wachter, *supra* note 4.

26. Benoit, *supra* note 22 (quoting Rob Kindler, head of mergers and acquisitions at Morgan Stanley).

27. For example, during the twelve month period ending June 30, 2016, Vanguard funds voted for directors- and board-related shareholder proposals 69 percent of the time and governance-related proposals 62 percent of the time. *Our Engagement Efforts and Proxy Voting: An Update*, VANGUARD, <http://about.vanguard.com/vanguard-proxy-voting/update-on-voting/index.html> [<https://perma.cc/8UEQ-A93S>].

28. Some argue that it was "the many institutional investors who eventually embraced activists in their search for better returns who gave these hedge funds their real clout." Joseph Fuller, Opinion, *How Activist Investors Became Respectable*, HARV. BUS. SCH. WORKING KNOWLEDGE (Nov. 17, 2015), <http://hbswk.hbs.edu/item/how-activist-investors-became-respectable> [<https://perma.cc/TBY3-DNMA>]. In this sense, U.S. activism may be edging closer to the styles prevalent in the U.K. and Europe. See Kate Burgess, *Confrontational Activism Rare in the UK*, FIN. TIMES (Jan. 3, 2016), <https://www.ft.com/content/d39997a0-a3f2-11e5-8218-6b8ff73aae15> (quoting a partner at a Magic Circle firm, who stated: "There is still the desire in the UK to do things behind closed doors. And Europe is even harder to break into.").

29. See *infra* Part I.A.

management in director elections and constitute the most adversarial form of activist engagement, now result in settlements roughly half the time: proxy contests were settled or ended following concessions by management in 40 percent, 52 percent, 48 percent, and 53 percent of cases in 2013, 2014, 2015, and 2016, respectively.<sup>30</sup> In these settlements, rather than humiliating and deposing incumbent directors via a consummated proxy contest, activist nominees typically join the board and then work alongside incumbents as colleagues.<sup>31</sup>

Activism has penetrated management thinking both by triggering self-preservation instincts (directors usually want to keep their jobs) and by changing the way boards think about shareholder value. This shift has earned the recognition of J.P. Morgan, another management-side adviser, that “[n]o recent development has influenced firms’ strategic and financial decision-making as profoundly”<sup>32</sup> as activism. Even Martin Lipton, a leading activism-defense lawyer (and founding partner of Wachtell Lipton), has acknowledged that “some shareholder activism should be ‘encouraged.’”<sup>33</sup>

Activism scholarship has not fully accounted for this convergence or its implications, especially as they affect the golden leash. The cooling in company-activist tensions suggests that the golden leash could be deployed more often and take on a larger role in the capital markets. With companies less hostile to activist involvement, a shift in opinion around the leash may enable its more frequent use. Specifically, if the reputational risk to industry veterans in accepting a third-party compensation arrangement like a golden leash abates they may become

30. SULLIVAN & CROMWELL LLP, 2016 U.S. SHAREHOLDER ACTIVISM REVIEW AND ANALYSIS, 18 (2016), [https://sullcrom.com/siteFiles/Publications/SC\\_Publication\\_2016\\_U.S.\\_Shareholder\\_Activism\\_Review\\_and\\_Analysis.pdf](https://sullcrom.com/siteFiles/Publications/SC_Publication_2016_U.S._Shareholder_Activism_Review_and_Analysis.pdf) [<https://perma.cc/LU22-H6ST>]. The 2016 numbers are through November 28, 2016. See *id.* at 1, 18. Boards of directors settle for a variety of reasons, whether to avoid the expense of a proxy contest (around \$10 million), minimize humiliation if they believe they will lose anyway, or to save their own jobs. See John C. Coffee, Jr., *The Lessons of DuPont: Corporate Governance for Dummies*, CLS BLUE SKY BLOG (June 1, 2015), <http://clsbluesky.law.columbia.edu/2015/06/01/the-lessons-of-dupont-corporate-governance-for-dummies> [<https://perma.cc/3FB4-M6SY>].

31. See Josh Black, *The Activist Investing Annual Review 2017*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 21, 2017), <https://corpgov.law.harvard.edu/2017/02/21/the-activist-investing-annual-review-2017> [<https://perma.cc/2WXR-P7HH>] (quoting an activist investor as saying that “[t]here is certainly a heightened willingness to settle between shareholders and management teams, and it tends to be [only] the most egregious cases” where a dispute flows into a full-on proxy fight). Settlements sometimes provide for activist nominees to join the board by replacing existing directors; other times, the board is enlarged as a condition of the settlement and the new directors are added.

32. CORP. FIN. ADVISORY, *supra* note 24, at 1; see also Benoit, *supra* note 22.

33. David Benoit, *Martin Lipton Names Some Activists He Respects*, WALL STREET J. (Mar. 28, 2014, 6:34 PM), <http://www.wsj.com/articles/SB10001424052702304688104579467300437514472>.

more willing to serve as designated director nominees. This seems plausible, if not a given.

But the *détente* has a darker potential as well. It suggests a need to sharpen the focus on fiduciary duties—specifically, the potential for conflicts of interest for designated directors who benefit from a golden leash—since it raises the possibility of collusion between activists and boards. Any form of blending of fiduciary duties carries some risk of abuse. However, if golden leash structures are harmful to the corporation or present opportunities for unjust enrichment of designated directors, then an increasingly accommodative approach by companies magnifies that risk.<sup>34</sup> In brief, golden leashes provide unusually lucrative opportunities for prospective directors, so to the extent boards are becoming more willing to settle with activists (as is widely believed to be the case), the golden leash could become a mechanism that allows incumbents to keep their jobs while facilitating, potentially, conflicts of interest between the “leashed” director and the company. This Part examines important shifts in activist tactics that counsel both optimism about the potential of the golden leash and attention to the challenges it creates for fiduciaries.

#### A. The Evolution of Activist Strategy and Tactics

The strategy and tactics of activist hedge funds have been detailed thoroughly in the literature. In general, activists seek abnormally positive returns by accumulating shares in a company they believe underperforms its peers, overpays or entrenches its managers, or fails to implement strategies that maximize value.<sup>35</sup> Activists’ focus on corporate governance targets the agency costs problem: the persistent challenge that principals face in disciplining their firms’ agents. Shifts towards dispersed, passive ownership of stock have compounded agency costs by replicating the problem at the mutual fund level.<sup>36</sup> Ronald Gilson and Jeffrey Gordon have noted the unique role of activists in reducing these costs by developing proposals and then securing decisive support

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34. The same could be said for other forms of selective supplemental director compensation, which have not attracted the same scrutiny as the golden leash. For example, as part of joining the board, independent directors are sometimes permitted to purchase a large volume of company stock at the pre-announcement price (i.e., a price that does not reflect the announcement that board is being refreshed). See *infra* note 44.

35. For example, activists often target companies that fail to sell off less profitable or less focused lines of business. See CORP. FIN. ADVISORY, *supra* note 24, at 5.

36. See generally Gilson & Gordon, *supra* note 15 (contending that a side effect of the rise of passive mutual funds has been the exacerbation of agency costs, through the concentration of ownership in a small number of large passive funds that have little incentive to advocate for governance changes, given their inability to capture returns on changes that benefit all holders equally).

from institutional owners.<sup>37</sup> In their seminal paper on the subject, they develop the concept of the activist as a governance entrepreneur or arbitrageur,<sup>38</sup> because the activist identifies weaknesses in governance and exploits them in a way that benefits ordinary shareholders as well as themselves.<sup>39</sup> To date, no type of minority<sup>40</sup> shareholder has proven more effective at motivating the boards of the corporations whose stock they own.

Activist investors typically acquire a toehold investment in a company—usually around 5 percent of its common stock, or a bit more<sup>41</sup>—disclose their stake, and launch a campaign to convince shareholders to dump underperforming incumbents in favor of directors nominated by the fund. Five percent is a “magic” ownership threshold in the sense that it triggers an obligation under the federal securities laws by the activist to disclose their stake.<sup>42</sup> The modest scale of their holdings does not confer sufficient power to impose changes unilaterally, so they leverage their reputation, rights as shareholders, their elite professional and social networks, and their media savvy<sup>43</sup> to persuade other shareholders to join them in pressuring the board to accept their nominees or in voting them in. If seated, these directors receive compensation from the corporation for their service, like any

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37. See *id.* at 897 (describing activists as “arbitraging governance rights that become more valuable through their activity monitoring companies to identify strategic opportunities and then presenting them to institutional investors for their approval”).

38. One might also consider effective, scrupulous activists to be market disciplinarians, since they operate as an invisible hand pressing fidelity to shareholder value over the private benefits of management.

39. See *id.* at 896–97.

40. “Minority” here refers to non-controlling shareholders. It is not uncommon for shareholders who hold a minority of a company’s equity, such as technology company founders, to maintain control over the company because they control a majority of votes through a dual-class share structure. Such investors are not in the position of “minority” shareholders in the usual sense.

41. Gilson & Gordon, *supra* note 15, at 899.

42. Once investors cross a beneficial ownership threshold of 5 percent, they must publicly disclose their stake within ten days of acquisition by filing a Schedule 13D or 13G (the former if they seek to influence management, the latter for passive holders). 17 C.F.R. § 240.13d-1(a)–(b) (2016) (establishing Schedule 13D requirement and criteria for filing Schedule 13G in lieu of 13D, respectively).

43. For example, when the fund Starboard Value launched a campaign against Darden Restaurants, the parent company of Olive Garden, it famously included among its 294 slides a claim that the Italian chain restaurant stopped salting its pasta water in order to maximize the warranties on its pots. The allegation seemed to symbolize everything wrong with the restaurant, and the presentation went viral. See David Benoit, *Starboard’s Olive Garden Slides: Salting the Water, Custom Straws and More*, WALL STREET J. (Sept. 12, 2014, 12:24 PM), <http://blogs.wsj.com/moneybeat/2014/09/12/starboards-olive-garden-slides-salting-the-water-custom-straws-and-more>; Erik Holm, *Readers Have Lots to Say on Salting Olive Garden’s Pasta Water*, WALL STREET J. (Sept. 12, 2014, 12:06 PM), <http://blogs.wsj.com/moneybeat/2014/09/12/readers-have-lots-to-say-on-salting-olive-gardens-pasta-water>.

other director. In addition, they are sometimes permitted to acquire stock from the company on favorable terms.<sup>44</sup>

The golden leash and other tools of shareholder activism have their roots in developments from a generation earlier. In the 1970s and 1980s, acquirers often launched hostile takeovers of entire companies. A series of changes, including the advent of the poison pill—which makes hostile takeovers functionally impossible by rendering them uneconomic—and the deference the pill and related takeover defenses were afforded in *Unocal Corp. v. Mesa Petroleum Co.*,<sup>45</sup> combined with economic changes to “shift[] takeover strategy to the proxy contest.”<sup>46</sup> Initially, these were full-slate proxy contests where outsiders sought control of the target corporation (by replacing the entire board or a majority).<sup>47</sup> However, the use of the full-slate proxy contest ebbed “as further innovation in takeover protection took root, most notably the poison pill-staggered board combination.”<sup>48</sup> Outside investors thus pivoted to nominating partial slates of candidates, where they merely sought board representation (not control), usually in the form of two to four seats.<sup>49</sup> The partial slate campaign “ha[s] now largely replaced control contests”<sup>50</sup> to become the leading activist weapon.<sup>51</sup>

44. For example, the company might sell the designated director shares of stock at the pre-announcement price (i.e., a price that does not reflect the announcement that the new director will join the board). This happens outside the context of activist campaigns, too. See, e.g., The Medicines Co., Current Report, (Form 8-K) (Aug. 25, 2015), [https://www.sec.gov/Archives/edgar/data/1113481/000110465915062611/a15-18761\\_18k.htm](https://www.sec.gov/Archives/edgar/data/1113481/000110465915062611/a15-18761_18k.htm) [<https://perma.cc/8UPU-GMYV>] (disclosing in a single filing that: (a) a high-profile executive and investor in the company’s industry was joining the company’s board as chairman; and (b) the company had sold him, via a private placement exemption, \$30 million worth of common stock, at the market price prior to disclosing this news).

45. 493 A.2d 946 (Del. 1985).

46. Cain et al., *supra* note 8, at 663; see also Ronald J. Gilson, *Unocal Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 503–07 (2001) (discussing the trend of unsolicited takeover attempts occurring through proxy contests rather than tender offers).

47. Cain et al., *supra* note 8, at 663–64.

48. *Id.* at 664; see also Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 904–07 (2002) (describing the significance of a staggered board in combination with a poison pill). The poison pill, or shareholder rights plan, is a defensive device triggered by an uninvited acquisition offer. When a company that has a pill in place receives such an offer (known as a “hostile bid”), the pill is triggered, enabling existing shareholders to add to their stake in the company at a discount and preventing the acquirer from obtaining a majority stake. The pill thus effectively makes it impossible to acquire a company merely by negotiating a price with shareholders and de facto requires the consent of the board of directors, which can vote to disable the pill.

49. Cain et al., *supra* note 8, at 664; see also William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1404 n.107 (2007).

50. Cain et al., *supra* note 8, at 664; see also SEC Grants No-Action Relief to Activist Shareholders Seeking to “Round Out” Short Slates With Each Other’s Nominees, GIBSON, DUNN & CRUTCHER LLP (Apr. 2, 2009), <http://www.gibsondunn.com/publications/pages/SECGrantsNo-ActionReliefToActivistShareholdersSeekingtoRoundOutShortSlates.aspx>

But however they proceed, activists hold only a minority position in a target company's stock. To be successful in driving change, activists must win the support of long-term investors like mutual funds (so-called long-onlys), which have pledged to support only strategies that improve enterprise value for the long term.<sup>52</sup>

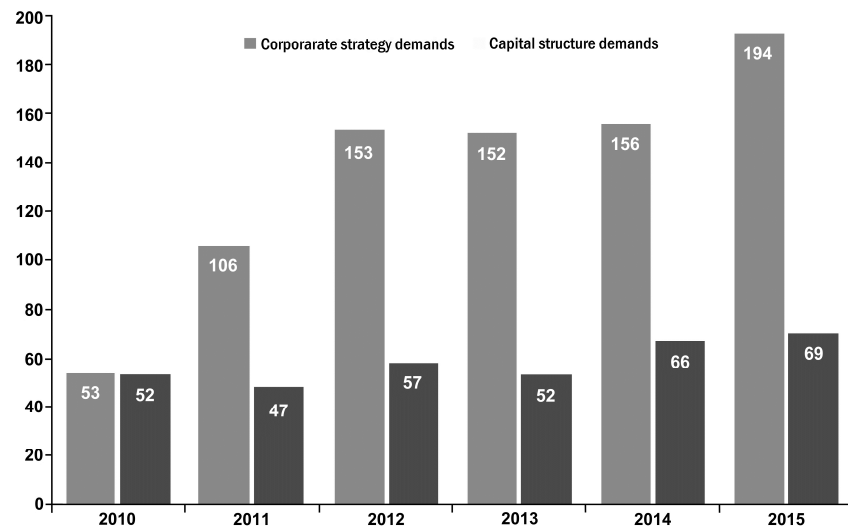
### B. Does "Short-Termism" Exist?

Where the topic of hedge fund activism is raised, the charge of "short-termism" is sure to follow. In brief, the existence of short-term incentives is popularly believed to "lead managers to 'hide bad news [and] inflate earnings,' assume too much risk, abandon profitable long term projects, and promote trendy, 'castle-in-the-air' projects in their place."<sup>53</sup> Recent studies have challenged the merits of this claim empirically,<sup>54</sup> and changes in activist hedge fund strategy suggest growing cause to question its premise. While "[s]hort-termism is the bugbear of the post-financial crisis capital markets,"<sup>55</sup> most activist campaigns today seek governance reforms and changes in strategic direction rather than the type of changes frequently maligned as short-termist.<sup>56</sup> As Figure 1 shows, these types of campaigns seeking changes in capital structure account for a shrinking share of activist demands. They are now outnumbered by campaigns for changes in corporate strategy and governance by almost three to one:<sup>57</sup>

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[<https://perma.cc/ECM4-NAYT>] ("[Running a short slate] is becoming the preferred approach for dissidents seeking board representation . . ."). But see, e.g., Julie Jargon et al., *Starboard Succeeds in Replacing Entire Darden Board*, WALL STREET J. (Oct. 10, 2014, 4:24 PM), <http://www.wsj.com/articles/darden-shareholders-elect-all-12-starboard-nominated-directors-1412949459> (reporting on Starboard's successful campaign to replace entire Darden Restaurants board through a proxy contest).

51. Of course, some activists do mount full-slate campaigns, including prominent ones. The Starboard campaign at Darden Restaurants is a good example. See Jargon et al., *supra* note 50.
52. See Gilson & Gordon, *supra* note 15, at 896–97.
53. James Cameron Spindler, Long-Term Incentives to Underperform in the Short Term 2 (July 18, 2016) (unpublished manuscript) (on file with the University of Texas School of Law) (alterations in original) (citations omitted).
54. See, e.g., Frank Partnoy, Opinion, *The Surprising Market Response to Activist Hedge Funds*, WALL STREET J. (Apr. 22, 2015, 7:01 PM), <http://www.wsj.com/articles/the-surprising-market-response-to-activist-hedge-funds-1429743683> [<https://perma.cc/8QRR-7JK3>]; see also Bebchuk et al., *supra* note 4.
55. Spindler, *supra* note 53, at 2.
56. Giles Turner, *The Activist Floodgates Are Open, J.P. Morgan Says*, WALL STREET J. (Aug. 7, 2015, 7:18 AM), <http://blogs.wsj.com/moneybeat/2015/08/07/the-activist-floodgates-are-open-j-p-morgan-says> (citing J.P. Morgan report based on SharkRepellent data for 2010–2015). Examples of measures intended, allegedly, to result in a quick increase in shareholder wealth in the short term include share buybacks and dividend issuances.
57. *Id.*

**Evolution of corporate strategy versus capital structure demands (2010–2015)<sup>1,2</sup>**


Source: SharkRepellent; years reflect respective proxy seasons (e.g., 2015 is from 07/01/14 – 06/30/15)

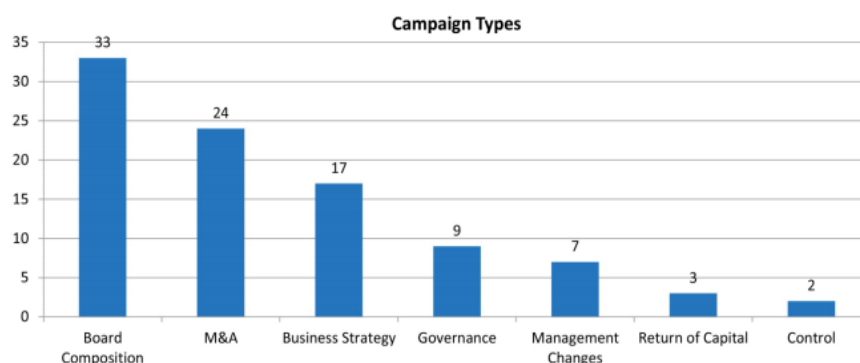
<sup>1</sup> Represents the following campaign types: board control and representation, enhance corporate governance, maximize shareholder value and remove director(s) and officer(s); classified by announcement date

<sup>2</sup> Individual campaigns may be classified under various value demand categories

FIGURE 1.<sup>58</sup>

A closer look at the trend reveals, if anything, an intensification of the shift towards strategic goals rather than capital structure objectives. As depicted in Figure 2, a study of 45 activist campaigns by the law firm Gibson, Dunn & Crutcher in the first half of 2016 found that only a small proportion (under 7 percent) sought a return of capital, while the bulk were directed at board representation, transactions, strategy, or governance:

58. *Id.*

FIGURE 2.<sup>59</sup>

Once standard, it is increasingly uncommon for activist campaigns to seek short-term outlays, like dividend declarations and share repurchases.

Among other things, this shift provides further evidence of a convergence of activist, company, and long-term investor interests. As such, it adds to the promise of the golden leash as an agency cost curb but also underscores the growing potential for abuse. After all, when the golden leash emerged on the scene, it was predictably and fiercely opposed by the target company's board. If the leash becomes normalized and a board is desperate to settle an activist campaign, the board might be willing to seat designated directors pursuant to a golden leash that is not structured optimally for shareholder value.

### C. The Mainstreaming of Activism

Activist engagements at two iconic American companies illustrate the growing convergence of company and activist interests that suggests fertile terrain for the golden leash. As it happens, both involved prominent activist investor Nelson Peltz. In the first, Peltz sought changes at the Pittsburgh-based Heinz Company in a colorful battle in 2006 that is now legendary. After rebuffing

59. GIBSON, DUNN & CRUTCHER LLP, GIBSON DUNN 2016 MID-YEAR ACTIVISM UPDATE 3 (2016), <http://www.gibsondunn.com/publications/Documents/MARreport-2016-Mid-Year-Activism-Update.pdf> [<https://perma.cc/F9KS-VDCT>] (figures compiled by law firm Gibson, Dunn & Crutcher based on forty-five campaigns). Some campaigns sought more than one goal, which is why the total is greater than forty-five. The minimum market capitalization of the target companies studied was \$1 billion. *See id.* at 2–3.



Peltz's demand for board seats,<sup>60</sup> Heinz management distributed custom-labeled bottles of its ketchup inscribed with messages urging employees to vote against the insurgents from Peltz's Trian Group.<sup>61</sup> The Pittsburgh newspaper ran editorials blasting Peltz's agenda and backing the "hometown team."<sup>62</sup> As the voting hour at the meeting approached, an elderly Heinz shareholder made a similar appeal, declaring to roars from the crowd: "I don't want the Trian people coming in from out of state."<sup>63</sup> Even the company's chief financial officer later recalled thinking, "Gosh we don't need outside help."<sup>64</sup> Nevertheless, Peltz ultimately won two seats on the board and is credited with helping to turn around the company despite vigorous internal opposition.<sup>65</sup>

In the aftermath of the Peltz-Heinz saga, activism surged. The year 2015 was a watershed.<sup>66</sup> Though activist hedge funds controlled \$120 billion in assets by year end,<sup>67</sup> in some ways even that impressive figure understates their influence on the thinking of boards of directors. In 2015, activists mounted more campaigns than in any year on record—nearly one every day on average<sup>68</sup>—and won board seats 127 times.<sup>69</sup> Nine companies in the Fortune 100 and 38 of the Fortune 500 were confronted with an activist campaign in 2015.<sup>70</sup> Of the latter group, four companies were targeted two or more times.<sup>71</sup> Activism as a phenomenon also edged towards a new reality: increasingly, the outsiders—activists—found themselves on the same team as the insiders. "[W]hile not exactly welcomed in corporate boardrooms, [activists now] are rarely treated as

60. See Shawn Tully, *The Reinvention of Nelson Peltz*, FORTUNE MAG. (Mar. 19, 2007, 11:02 PM), [http://archive.fortune.com/magazines/fortune/fortune\\_archive/2007/04/02/8403476/index.htm](http://archive.fortune.com/magazines/fortune/fortune_archive/2007/04/02/8403476/index.htm) [<https://perma.cc/63XB-LKBR>]; see also Ramesh Santanam, *Heinz Board Nixes Shareholder Growth Plan*, ASSOCIATED PRESS (May 24, 2006, 9:23 PM), <http://www.washingtonpost.com/wp-dyn/content/article/2006/05/24/AR2006052402501.html> [<https://perma.cc/C6T8-9SPX>].

61. Benoit, *supra* note 22.

62. *Id.*

63. Sean D. Hamill & Andrew Ross Sorkin, *Peltz Is Seen With 2 Seats at Heinz*, N.Y. TIMES (Aug. 17, 2006), <http://www.nytimes.com/2006/08/17/business/17heinz.html>.

64. Benoit, *supra* note 22.

65. See Tully, *supra* note 56.

66. See, e.g., Benoit, *supra* note 22 (noting that in 2015, shareholder activists came to manage double the quantum of assets they managed three years prior, "infiltrate[ed] the boardrooms of large companies like never before," launched more campaigns than any year to date, and won more board seats in those campaigns than ever before).

67. *Id.*

68. See *id.* (reporting 360 campaigns launched in 2015).

69. David Benoit, *Activists' Sway Shows Its Limits*, WALL STREET J. (Feb. 1, 2016, 12:47 PM), <http://www.wsj.com/articles/activists-sway-shows-its-limits-1454292851>.

70. Governance Insights Ctr., *10Minutes on Hedge Fund Activism: Strategies for Staying Out of Activist Cross Hairs*, PRICEWATERHOUSECOOPERS, <http://www.pwc.com/us/en/10minutes/hedge-fund-activism.html> [<https://perma.cc/E8EC-FFSM>].

71. *Id.*

ill-mannered outsiders,” reported the *Wall Street Journal* in a retrospective dedicated to activism in 2015.<sup>72</sup> J.P. Morgan dubbed this paradigm shift an “activist revolution.”<sup>73</sup>

A second Peltz engagement in 2015, which likewise involved a classic American brand, suggests the extent of this change. When the General Electric Company (GE) announced that it would spin off its finance arm, the company CEO proactively approached Peltz. The CEO invited the activist—who did not own GE stock at the time—to invest in the company and become active in reforming it.<sup>74</sup> Peltz agreed, the board approved his suggestions, and ultimately he injected \$2.5 billion into the company, his firm’s largest investment ever. The strategy was viewed as a success,<sup>75</sup> which, in turn, cast the activist-board collaboration in a positive light. The idea that a blue-chip American company would not merely make peace with but proactively seek out an activist investor to help execute on company strategy would have been unthinkable just a few years prior.

The Heinz and GE engagements are two high-profile data points that signify a broader change in paradigm, not only economically but culturally. Even at companies that do not have activists on the board, the relentless activist focus on value and governance is increasingly suffusing management thinking and contributing to the mainstreaming of shareholder activism.<sup>76</sup> (“We’re the activists at UTC,” the CEO of the industrial giant United Technologies Corporation recently declared.)<sup>77</sup> Yet legal theory and doctrine continue to espouse an adversarial conception of activists and companies, perhaps reflecting a vestigial hostility towards activism that many target companies themselves have, ironically, since discarded. A shift in activist priorities towards broader long-term changes offers further support for a new, collaborative (or at least less adversarial) conception of activist-company interests. Changes in law have accompanied this shift in market trends, making it harder for activists<sup>78</sup>

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72. Benoit, *supra* note 22.

73. CORP. FIN. ADVISORY, *supra* note 24.

74. See Benoit, *supra* note 22.

75. The General Electric Company’s (GE) stock price appreciated considerably. In 2016, U.S. regulators, who had deemed GE Capital “too big to fail” and thus subject to additional rules, lifted the designation. Ted Mann & Ryan Tracy, *GE Capital Sheds ‘Systemically Important’ Label*, WALL STREET J. (June 29, 2016, 7:11 PM), <http://www.wsj.com/articles/ge-capital-sheds-systemically-important-label-for-too-big-to-fail-firms-1467205963>.

76. The normalization of activism was the subject of a lengthy *Wall Street Journal* article. See Benoit, *supra* note 22.

77. *Id.* (emphasis added).

78. For example, activists can no longer take over a company in secret. See 17 C.F.R. § 240.13d-1 (2016) (requiring disclosure of beneficial ownership of more than 5 percent of a company’s outstanding stock within ten days). Shareholder approval is also required for dispositions of all or substantially all the assets of a corporation. DEL. CODE ANN. tit. 8, § 271 (2016).

and boards<sup>79</sup> to employ certain aggressive tactics. Even where the activist-board relationship is initially adversarial, it often does not remain that way: activists who try to join a board end up succeeding most of the time,<sup>80</sup> and existing law provides little guidance on the fiduciary duties of activist directors in the post-campaign phase, when activists and incumbents work alongside one another as colleagues for months or possibly years.

## II. THE GOLDEN LEASH AND PROCEDURAL CORPORATE GOVERNANCE

The challenge of identifying “the optimal division of control between shareholders and management” is a central and vexing issue in corporate finance scholarship.<sup>81</sup> The board of directors is the institution charged with primary responsibility for mediating the interests of these groups.<sup>82</sup> It is the instantiation of the separation of ownership and control, the phenomenon famously identified by Adolf Berle and Gardiner Means.<sup>83</sup> But the modern model of the board still allows effective control of a firm by executives, so long as such control is exercised indirectly, through formally independent directors. Further, the business decisions of such boards (run by independent directors) generally benefit from the business judgment rule standard of review. In the aggregate, these changes have reconfigured the problem of agency costs, but have not resolved it.

As a practical matter, “[t]housands of widely dispersed shareholders cannot run a corporation themselves: the board and corporate executives manage it for them.”<sup>84</sup> Locating the policymaking function at the board level, rather than with the shareholders, virtually ensures that “important decision agents do not bear a

79. See Benoit, *supra* note 22 (noting that the number of S&P 500 companies with staggered boards had dwindled from 300 in 2000 to 49 in 2015, making it harder for boards to insulate themselves from insurgents).

80. See SULLIVAN & CROMWELL LLP, *supra* note 30, at 12 (presenting data demonstrating “remarkabl[e] consistent rate” of activist campaigns resulting in board seats of 54 to 62 percent of completed campaigns between 2013 and 2016).

81. Jonathan B. Cohn et al., *On Enhancing Shareholder Control: A (Dodd-) Frank Assessment of Proxy Access*, 71 J. FIN. 1623, 1623 (2016).

82. Most states require that locally chartered corporations adopt a board-centric model of governance. Delaware’s Supreme Court has gone so far as to declare it a “cardinal precept” that members of the board of directors, “rather than shareholders, manage the business and affairs of the corporation.” *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), *overruled by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); accord DEL. CODE ANN. tit. 8, § 141(a) (2016) (providing that a corporation “organized under this chapter shall be managed by or under the direction of a board of directors”).

83. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

84. Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 451 (2008).

substantial share of the wealth effects of their decisions,”<sup>85</sup> the classic definition of agency costs. Further, the practice, now common, of requiring a majority or supermajority of independent directors has been derided for elevating, even “fetishizing,” independence over critical substantive qualifications.<sup>86</sup>

The activist strategy capitalizes on the flaws in the modern independent board,<sup>87</sup> and the golden leash advances their efforts.<sup>88</sup> In addition to its potential to produce superior investment returns, the golden leash can yield benefits for governance and by extension the market as a whole.

### A. The Rise of the Independent Director

Independent boards became the norm at large public companies around the end of the twentieth century.<sup>89</sup> By that time, the two leading U.S. exchanges, the New York Stock Exchange and NASDAQ, had come to require that the boards of listed companies contain a majority of independent directors.<sup>90</sup> While Delaware law still does not require an independent board, as a practical matter it favors majority-independent boards. When challenged in shareholder litigation, for example, transactions approved by such boards are evaluated under the more deferential business judgment rule rather than the entire fairness standard, even where the transaction is with a controlling shareholder.<sup>91</sup>

The promise of independence as a check on management remains unfulfilled. This is partly because of the narrowness of “independence” definitions that exist in the primary sources of regulation. The NYSE independence test merely bars

85. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301 (1983).

86. Rodrigues, *supra* note 84, at 451.

87. See Theo Francis & Joann S. Lublin, *Boards Get More Independent, but Ties Endure*, WALL STREET J. (Jan. 19, 2016, 3:16 PM), <http://www.wsj.com/articles/boards-get-more-independent-but-ties-endure-1453234607>.

88. See, e.g., Nili, *supra* note 8 (contending that the golden leash has the potential to reduce agency costs); see also *supra* Part I; cf. Gilson & Gordon, *supra* note 15 (positing activism itself as a mechanism for reducing agency costs).

89. See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1465 (2007) (“Between 1950 and 2005, the composition of large public company boards dramatically shifted towards independent directors, from approximately 20% independents to 75% independents.”).

90. See EQUITY RULES § 5605(b)(1) (NASDAQ STOCK MKT. 2017); N.Y. STOCK EXCH., LISTED COMPANIES MANUAL § 303A.01 (2016).

91. See *In re MFW S’holders Litig.*, 67 A.3d 496 (Del. Ch. 2013). Where the company has a controlling shareholder, a merger between the company and such shareholder will receive the protection of the business judgment rule where, among other things, the transaction is (1) negotiated and approved by an independent committee that has the power to vote down the transaction definitively and (2) approved by a fully-informed, non-coerced vote of a majority of the minority shareholders (i.e., a majority of the non-controlling shareholders). *Id.* at 524–36.

“material relationship[s] with the listed company.”<sup>92</sup> The NASDAQ version prohibits any “relationship with the listed Company that would impair [the director’s] independence,” a slightly more demanding standard.<sup>93</sup> In both cases, the independence determination is made in the first instance by the company’s own board, which of course introduces the possibility of a conflict. The independence standard under Delaware law is more subjective and arguably more robust. Delaware’s analysis is fact-specific and considers factors including employment by or other material financial ties to the company as well as personal connections.<sup>94</sup> Unlike stock exchange rules, under Delaware law a social relationship with an interested person may destroy a director’s independence as to a given transaction, though the relationship must be material.<sup>95</sup>

A body of literature asserts that the ascendance of the independent-dominated board has heightened the agency costs problem, by making it easy for boards to nominate management-friendly directors who meet stock exchange and Delaware independence standards but do not act as a meaningful check on management.<sup>96</sup> Even where no strong personal ties exist, structural features of independent-run boards, including independent directors’ minimal time investments and inferior access to information, complicate the project of conducting meaningful oversight.<sup>97</sup> This is setting aside other important questions, such as the competence of the independent directors.

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92. N.Y. STOCK EXCH., *supra* note 90, at § 303A.02(a)(i).

93. EQUITY RULES § 5605(a)(2).

94. See Jay P. Lefkowitz, *Director Independence: Interplay Between Delaware Law and Exchange Rules*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 7, 2013), <https://corpgov.law.harvard.edu/2013/10/07/director-independence-interplay-between-delaware-law-and-exchange-rules> [<https://perma.cc/C4WB-DXYX>].

95. See *id.* British Prime Minister Theresa May has taken an interest in this issue. See Kylie MacLellan, *Key Excerpts From the Leadership Launch of Britain’s Theresa May*, REUTERS (July 11, 2016, 9:45 AM), <http://www.reuters.com/article/us-britain-eu-may-idUSKCN0ZR1MY> [<https://perma.cc/P343-Z9DU>]. In a speech on the eve of assuming her premiership, May devoted an unusual amount of attention to the topic of corporate governance. *Id.* Her comments related to the U.K., but echoed longtime critiques of U.S. corporate governance: “The people who run big businesses are supposed to be accountable to outsiders, to [outside] non-executive directors who are supposed to ask the difficult questions, think about the long-term and defend the interests of shareholders.” *Id.* “In practice, they are drawn from the same, narrow social and professional circles as the executive team and—as we have seen time and time again—the scrutiny they provide is just not good enough.” *Id.*

96. See, e.g., Rodrigues, *supra* note 84, at 452 (urging a rejection of the “fetishization” of the independent board structure, which “do[es] not ensure proper corporate governance”).

97. See Francis & Lublin, *supra* note 87 (“Today, most large companies can boast that their boards are overwhelmingly independent under rules laid down by the stock exchanges. Yet some of those independent directors have close ties to the companies and executives they oversee, or to one another.”). Independence in this sense is required by the major listing exchanges.

The independent-run board is not structured to curb agency costs. The imperative to staff a board with independents requires management to formally submit to outside supervision, but affords executives great influence in selecting their own overseers.<sup>98</sup> An independent directorship at a large company is a prestigious role asking five hours of work per week for \$255,000 in median annual salary.<sup>99</sup> This workload, which is reported by directors themselves, amounts to a wage of approximately \$1,000 an hour, and much of the labor is passive and relatively unaccountable (e.g., sitting in on ten to fifteen person conference calls). As has been widely documented, this combination has led to effective capture of independent directors,<sup>100</sup> often promoting a go-along-to-get-along culture, the appointment of yes-men, and groupthink. The radical information asymmetry that exists among board members is one example. Management controls all material nonpublic corporate information and shares it selectively in “board books”—document dumps running into the hundreds of pages—circulated to the independent directors days before important meetings with little opportunity for follow-up.

There is also evidence that the structure of director compensation, which now often takes the form of half equity and half cash (instead of all cash),<sup>101</sup> does little to accomplish its stated goal of promoting higher performance. A director’s service is primarily motivated by other factors, such as prestige and enhancing

98. As a formal matter, the process by which a public corporation selects independent directors is managed by its incumbent independent directors. See N.Y. STOCK EXCH., *supra* note 90, at § 303A.04(b)(i) (mandating that new independent directors either be “identif[i]ed” and “select[ed]” by a nominations and governance committee consisting entirely of independent directors or “recommend[ed]” as nominees by such committee to the board); Listing Rules § 5605–6(e)(1) (NASDAQ STOCK MKT. 2017) (new independent directors to be selected by a majority of the independent directors of the board in a vote in which only independents participate or by a nominations committee consisting only of independent directors). In practice, however, CEOs often exert great influence over the process.

99. See Theo Francis & Joann S. Lublin, *Corporate Directors’ Pay Ratchets Higher as Risks Grow*, WALL STREET J. (Feb. 24, 2016, 3:29 PM), <http://www.wsj.com/articles/corporate-directors-pay-ratchets-higher-as-risks-grow-1456279452> (quoting figure for median pay of a director at an S&P 500 company). Boards are increasingly adopting caps on the size of equity grants their directors can receive, which is intended to provide cover in the event of shareholder litigation alleging excessive director pay. See Jena McGregor, *The Part-Time Job That Can Pay More Than \$250,000 a Year*, WASH. POST (July 20, 2016), <https://www.washingtonpost.com/news/on-leadership/wp/2016/07/20/pay-for-corporate-directors-creeps-higher-to-263500-a-year/> [<https://perma.cc/PL66-V5C9>] (noting that caps have been adopted by 42 percent of companies and half of those caps had been adopted or amended since 2015).

100. See, e.g., Yaron Nili & Kobi Kastiel, *“Captured Boards”: The Rise of Super Directors and the Case for a Board Suite*, 2017 WIS. L. REV. (forthcoming 2017); see also, e.g., Charles M. Elson, *Director Compensation and the Management–Captured Board—The History of a Symptom and a Cure*, 50 S.M.U. L. REV. 127 (1996).

101. This change in structure represents a major shift. An early and energetic case for paying independent directors with equity is presented in Elson, *supra* note 100.

their profile for other assignments. Independent directors, as a group, may not possess the combination of information, company experience, and motivation necessary to optimize a company's performance.<sup>102</sup> They "are looked on as caretakers. . . . [and] get a decent salary for not a lot of work"<sup>103</sup>—and, a cynic might add, for approving management's decisions. Boards generally operate by consensus, with little incentive to speak up against management.

Designated directors, whatever their drawbacks, do not suffer from these infirmities. For example, they are less vulnerable to information capture, because their nominating fund generally supplies them with briefing books analyzing company information prior to board meetings.<sup>104</sup> And since they generally agree to serve on the board in exchange for enormous incentive pay from their nominating fund—in the form of equity in the fund or a golden leash—they have ample financial incentive to maximize the company's performance.

## B. The Golden Leash: Rationales, Structures, and Precedents

As noted in Part I, activists historically have sought to appoint principals of the fund to the boards of their targets. Such individuals are by definition professional activist investors, and tend to be subject-matter generalists. However, in certain situations they may prefer to nominate independent veterans<sup>105</sup> of the company's industry who have more relevant experience and may have more credibility with the institutional investors whom the activists must court.

Enter the golden leash. Its logic is pragmatic and straightforward. As Steven Davidoff Solomon has explained, "if you need good people to run for these positions and clean up the company, it is going to cost money. Most of the people

102. The imposition of enhanced fiduciary duties by courts may serve as a partial corrective to the ineffectiveness of independent directors but cannot serve as a structural solution to what is ultimately a business problem. *Cf.* William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 739 n.18 (2001) (noting the limitations of fiduciary rules, which "no one commends . . . as the means to the end of bridging the separation of ownership and control").

103. Steven Davidoff Solomon, *Upping the Ante in a Play for a Stronger Board*, N.Y. TIMES: (Apr. 2, 2013, 6:31 PM), [http://dealbook.nytimes.com/2013/04/02/upping-the-ante-in-a-play-for-a-stronger-board/?\\_r=1](http://dealbook.nytimes.com/2013/04/02/upping-the-ante-in-a-play-for-a-stronger-board/?_r=1) [<https://perma.cc/BXG7-DTAD>].

104. They often share these analyses with the rest of the board.

105. For purposes of the New York Stock Exchange and NASDAQ listing rules, designated directors with a golden leash in general qualify as independent directors, as they are independent of company management. *See* EQUITY RULES § 5605(a)(2) (NASDAQ STOCK MKT. 2017); N.Y. STOCK EXCH., *supra* note 90, at at § 303A.02(a)(i). For purposes of Delaware law, the inquiry would turn on whether the director has a material connection that would compromise his judgment with respect to a particular transaction. *See In re MFW S'holders Litig.*, 67 A.3d 496 (Del. Ch. 2013).

the hedge funds have nominated have better things to do than walk around with a bull's-eye on their backs."<sup>106</sup>

Golden leash arrangements for designated directors tend to be formulaic in nature: they specify a fixed compensation formula *ex ante*. This deprives the activist of the opportunity to threaten modifications of the leash to influence the director's judgment once she joins the board. As explained in a recent presentation by the leading activist hedge fund Jana Partners, golden leash arrangements are commonly structured as guaranteed incentive compensation, conditional incentive compensation, or a mix.<sup>107</sup> Whichever form is chosen, the compensation is paid by the activist hedge fund to the director on top of the pay the director receives from the corporation for her service.

Guaranteed incentive compensation usually provides a director with an equity stake in the company. It is "structured to have value no matter how the stock performs, such as by granting a certain amount of stock."<sup>108</sup> Such an arrangement aligns director compensation with stock performance, but because the director's stock vests immediately, it "also results in compensation being awarded even if the stock declines (unless it goes to zero)."<sup>109</sup> Accordingly, the guaranteed incentive compensation method is open to the criticism that it enriches nominees simply for agreeing to serve. By contrast, conditional incentive compensation is more akin to a bonus: it kicks in only if a specified target is met. Thus, this structure only delivers value to the director if the stock price increases.<sup>110</sup> Jana has stated that it prefers this latter type of arrangement, which ensures that designated directors only benefit if shareholders at large benefit.<sup>111</sup> However structured, the incentive is paid by the activist and adds to the salary the designated director receives from the corporation (like every other director) for her service.

Two proposed golden leash arrangements, detailed in the emerging literature on the golden leash,<sup>112</sup> were both examples of the conditional incentive compensation model, with a relatively small amount guaranteed as well. If implemented, designated directors named pursuant to each arrangement could

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106. Solomon, *supra* note 103.

107. See Prestidge, *supra* note 8, at 315–16; see also Nili, *supra* note 8, at 531, 532 tbl.2.

108. JANA PARTNERS LLC., SUPPLEMENTAL PRESENTATION TO PROXY ADVISORS (2013), [https://www.sec.gov/Archives/edgar/data/943003/000110465913023600/a13-6908\\_3ex99dh.htm](https://www.sec.gov/Archives/edgar/data/943003/000110465913023600/a13-6908_3ex99dh.htm) [<https://perma.cc/FLF5-H53L>].

109. *Id.*

110. *Id.*

111. *Id.*

112. For further details, see Andrew A. Schwartz, *Financing Corporate Elections*, 41 J. CORP. L. 863, 880 (2016) ("[T]he golden leash is [among other things] a campaign contribution paid by one shareholder to a director-candidate in a contested proxy contest."); Cain et al., *supra* note 8; Prestidge, *supra* note 8; and, see especially Nili, *supra* note 8, at 524–30.



have received total compensation vastly in excess of the median pay that a director of an S&P 500 company receives (currently \$255,000).<sup>113</sup> Each was highly controversial. A brief review of their terms<sup>114</sup> illustrates some of the tensions involved.

First, in 2012, Jana announced it would seek to replace members of the board of Agrium Inc., a Canadian fertilizer company. The fund proposed to pay its nominees a retainer of \$50,000 each, plus “a collective total of 2.6% of Jana’s net gain on the investment.”<sup>115</sup> In the second case, a 2013 battle between Elliott Management and Hess Corporation, Elliott announced a similar plan: its nominees were paid a \$50,000 retainer, and if seated, stood to receive an additional \$30,000 for each percentage point by which the company outperformed its peers during a three-year window.<sup>116</sup> The funds justified these arrangements by “the need, first, to get the right people onto their slates and, second, to incentivize those people, once elected, to push the company to outperform.”<sup>117</sup> This second justification was key in the case of Elliott’s golden leash, under which the total potential payout reached \$9 million per nominee. However, no director would have received such a prodigious sum unless the company did extremely well—under the terms of the leash, it would have had to outperform its peers by 300 percent—which naturally would have been of enormous value to the shareholders at large, not only the designated directors.<sup>118</sup> Ultimately, the controversies over both became moot: Jana’s nominees were defeated (for reasons unrelated to the golden leash), and Hess settled with Elliott’s nominees after they agreed to forgo golden leash compensation.<sup>119</sup>

In 2014, an activist fund succeeded for the first time in naming a candidate to the board pursuant to a golden leash when, after a bitter fight, Dow Chemical agreed to seat two candidates, Raymond J. Milchovich and Robert S. Miller, both former CEOs in the industrials space, nominated by the Third Point fund.<sup>120</sup> Each nominee received a fixed sum upon nomination and another payment upon

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113. See Francis & Lublin, *supra* note 99.

114. For additional discussion of these structures, see Nili, *supra* note 8, at 523–28.

115. Cain et al., *supra* note 8, at 651–52. As the authors note, Jana’s first golden leash arrangement actually predated its Agrium engagement by five years and was disclosed at that time, but it did not receive public attention and was mooted by the subsequent sale of the target company prior to its annual meeting. *Id.* at 651 n.5.

116. See *id.* at 652, 668.

117. *Id.* at 652.

118. See Solomon, *supra* note 103.

119. See Cain et al., *supra* note 8, at 668–69.

120. See *id.* at 653–54 (noting that Third Point’s nominees later became the first designated directors to be compensated pursuant to a golden leash arrangement). The Third Point nominees were renominated by Dow in the 2016 proxy season and were reelected. See Dow Chem. Co., Proxy Statement (Schedule 14A) (Apr. 1, 2016), <https://www.sec.gov/Archives/edgar/data/29915/000119312516527860/d111044ddef14a.htm> [<https://perma.cc/BK22-TUTA>].

appointment, if seated (these were \$250,000 each).<sup>121</sup> But the more powerful incentive came in the form of stock appreciation rights (SARs).<sup>122</sup> Milchovich and Miller received SARs worth potentially tens of millions of dollars. Of course they only make this money if the stock does *very* well, i.e., if the company's common shareholders collectively earn billions and billions of dollars.

The structure of the golden leash used by Third Point in its Dow engagement shows that valid concerns—specifically, the worry that the arrangement will drive a wedge between the interests of the director and the interests of the stockholders as a whole—can be managed. As structured in the agreement with Third Point, the SARs vest gradually, with a new round kicking in each year over five years contingent on the continued service of Milchovich and Miller as of the vesting date.<sup>123</sup> As the name implies, the value is tied to the appreciation of the company's stock, aligning their interests with those of common shareholders. They must also agree to stand for election each year and may not resign, even if Third Point ceases to be a stockholder of Dow.<sup>124</sup> In addition, while they were paid \$250,000 each upon joining the board, they were obligated to turn around and purchase \$250,000 in Dow stock upon doing so.<sup>125</sup>

The history of the Dow-Third Point engagement is still being written, but what is clear so far is that the company is executing on the strategy advocated by Third Point and many shareholders, including, crucially, reaching an agreement to merge with chief rival DuPont; receiving antitrust approvals for that merger; and replacing the CEO of Dow. Prior to the Dow engagement, some activists eschewed the practice of offering supplemental director compensation.<sup>126</sup> If the experience is ultimately seen to have delivered value for Dow shareholders, the market may regard that as a validation of a once-controversial practice and may warm to it.

### C. Procedural Corporate Governance

The golden leash has been promoted as a way to curb agency costs and as a mechanism for improving shareholder value. However, a legitimized golden leash could also lead to benefits sounding in procedural corporate governance.

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121. See Dow Chem. Co., *supra* note 120.

122. See *id.*

123. See *id.*

124. See *id.*

125. See *id.*

126. At this time, the golden leash is not universally embraced, even among activist hedge funds. Some leading activists, including William Ackman's Pershing Square Capital Management, continue to disavow the use of the golden leash entirely, "perhaps in part to avoid [controversy]." Prestidge, *supra* note 8, at 315.

Corporate governance has been described as having substantive and procedural components.<sup>127</sup> The concept of substantive corporate governance refers to the pursuit of outcomes that maximize enterprise value while observing certain social welfare minima.<sup>128</sup> The key inquiry is, did corporate policy “actually result in a good outcome for the corporation?”<sup>129</sup> This outcome-focused conception also embraces certain stakeholder rights through regulation and corporate initiatives designed to protect the environment, workers, consumers, and investors.<sup>130</sup>

Procedural corporate governance, by contrast, consists of rules and norms that construct “the system by which the corporation makes fundamental decisions.”<sup>131</sup> Among other things, this system refers to “the assignment of separate powers to management, shareholders, and boards of directors, [and] the procedures for selecting and removing members of boards of directors.”<sup>132</sup> It also resides in the requirement of shareholder approval for certain important corporate actions, including changes to the charter<sup>133</sup> or bylaws,<sup>134</sup> the sale of the corporation or the disposition of substantially all its assets,<sup>135</sup> the approval of stock option plans<sup>136</sup> and director and officer indemnification policies,<sup>137</sup> and the dissolution of the corporation.<sup>138</sup> These requirements are necessary but not sufficient, since a procedurally correct decision cannot cure a substantively prohibited action.

This elaborate structure is intended to bolster legitimacy by grounding business decisions and outcomes in a process seen as fair. It also reduces frictions with key stakeholders, including shareholders, courts, regulators, and the public.

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127. See, e.g., Cary Coglianese, *Legitimacy and Corporate Governance*, 32 DEL. J. CORP. L. 159, 161–62 (2007); David P. Porter, *Institutional Investors and Their Role in Corporate Governance: Reflections by a “Recovering” Corporate Governance Lawyer*, 59 CASE W. RES. L. REV. 627, 632–39 (2009).

128. See Coglianese, *supra* note 127, at 161–62; Porter, *supra* note 127, at 632–34.

129. Porter, *supra* note 127, at 632.

130. See generally Coglianese, *supra* note 127, at 161–62 (noting the essential role of regulation in ensuring that “even properly constituted corporations with fully functioning boards of directors (a test of procedural legitimacy) cannot take actions that will pollute the environment, treat their workers badly, or take money from investors”).

131. Porter, *supra* note 127, at 632.

132. Coglianese, *supra* note 127, at 161–62.

133. See DEL. CODE ANN. tit. 8, § 242 (2016).

134. *Id.* § 109(a). While corporations commonly delegate the power to adopt bylaws to the board, see *id.*, shareholders nonetheless retain concurrent authority in that domain. See *id.* (“The fact that such power has been so conferred upon the directors . . . shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws.”).

135. See DEL. CODE ANN. tit. 8, § 251(c).

136. See 26 C.F.R. § 1.422-3 (2016). In addition, advisory “say on pay” votes by shareholders on executive compensation are also required of many public companies. See 17 C.F.R. § 240.14a-21 (2016).

137. See DEL. CODE ANN. tit. 8, § 102(b)(7) (authorizing amendments to the certificate of incorporation excluding liability for breaches of fiduciary duty).

138. See *id.* § 275.

Ideally, procedural corporate governance requirements increase the likelihood of better business outcomes, on the whole if not necessarily in every case.

Procedural corporate governance also provides tangible and immediate legal benefits. The business judgment rule is a leading example. Sensitive to their own limitations, courts have articulated a doctrine that enables boards to insulate such decisions from judicial review: absent waste, fraud, or self-dealing, decisions of the board made pursuant to proper procedure are virtually immune to court scrutiny.<sup>139</sup> As one commentator has explained:

[W]e punish directors not for making the wrong decision but for not working hard enough in making their decision. Procedural corporate governance is a major component of a director's duty of due care, and failures of governance process can be so grossly negligent that they form the basis for a viable complaint against the director for breach of the duty of due care. In contrast, poor substantive corporate governance, that is, poor judgment, is unlikely to result in a viable claim against a director absent bad faith.<sup>140</sup>

This dichotomy leaves business decisions, which “are inherently all about risk and risk-taking,” to the board, restricting the judicial inquiry to judicially manageable questions regarding fiduciary duties and promoting efficiency of corporate decision-making.<sup>141</sup> In this sense, the business judgment rule operates as an abstention doctrine.<sup>142</sup>

Embedded in the business judgment rule is a value favoring deliberation among board members. Together with a co-author, Vice Chancellor Laster has argued that Delaware law mandates “an opportunity for all directors to participate in the board's decision-making process,” which includes not only a right to be heard but also a “concomitant right of every other director to benefit from each director's insights.”<sup>143</sup> The basic logic of this scheme can be extended beyond the firm. The golden leash places activists in a position where they must persuade industry veterans who are not activist investors of the wisdom of their strategy, who in turn must persuade the board. The golden leash does more than create incentives; it elevates procedure and the deliberative process.

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139. See *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996) (“[I]n the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith.”).

140. Porter, *supra* note 127, at 634 (footnotes omitted).

141. *Id.* at 634–35.

142. See Bainbridge, *supra* note 19.

143. Laster & Zeberkiewicz, *supra* note 4, at 37.

As a recruitment device, the golden leash provides a vehicle for fostering conversations with industry veterans. To persuade veterans to join, activists must win over executives who often came up in the traditional “company man” mold and who likely know the target company’s business better than the activist investors themselves. While not a straightforward application of procedural corporate governance, the consultative process the golden leash fosters advances similar goals of consensus-building, information-gathering, and the building of legitimacy through trust and reputation. Enabling wider use of the golden leash thus has the potential to cement the shift in activist strategy away from measures directed at the quick return of capital<sup>144</sup> and towards governance reforms with broad appeal. Analogies from two other areas—the VC ecosystem and the practice of directors sharing information outside the firm—provide additional support for the view that enabling dialogue between directors and outside investors can facilitate gains in capital formation, quality of advice, and legitimacy.

### III. THE FIDUCIARY CRITIQUE OF THE GOLDEN LEASH

The golden leash debate has become a proxy war between supporters and opponents of shareholder activism. Yet claims that the golden leash affects the board’s investment horizon are only one category of critique. Another concern, potentially more grave but subtler, is the comparatively banal possibility that a designated director’s fiduciary duty of loyalty to the corporation might be compromised by a golden leash in the first place. This “fiduciary critique” suggests a need for closer attention to the structure and operation of the golden leash. Specifically, the central inquiry is whether the golden leash sets up incentives that divide the designated director’s interests from those of the ordinary shareholder<sup>145</sup> in such a way that would compromise the director’s fiduciary duty of loyalty to the corporation.

A threshold question concerns the nature of the designated director’s status as a fiduciary. Agents owe “a fiduciary duty to act loyally for the principal’s benefit in all matters connected with the agency relationship.”<sup>146</sup> It is well established that directors, as agents of the corporation-principal, owe a duty to act loyally for its benefit.<sup>147</sup> This includes designated directors. However, it is less clear that a

144. Carl Icahn’s high-profile campaign to persuade Apple, Inc. to return capital to shareholders via \$50 billion in stock buybacks is emblematic of “old style” activism. See Daisuke Wakabayashi, *Apple Repurchases \$14 Billion of Own Shares in Two Weeks*, WALL STREET J. (Feb. 6, 2014, 9:39 PM), <http://www.wsj.com/articles/SB10001424052702303496804579367543198542118>.

145. See generally Nili, *supra* note 8 (characterizing this critique).

146. RESTATEMENT (THIRD) OF AGENCY § 8.01 (AM. LAW INST. 2006).

147. See, e.g., *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

golden leash sets up a second fiduciary relationship, between the director and the nominating fund. “[T]he term ‘fiduciary’ signifies that an agent must act loyally in the principal’s interest as well as on the principal’s behalf.”<sup>148</sup>

The notion that a designated director with a contract providing for third-party compensation would likewise owe a fiduciary duty to the third party is a stretch. Such a director has an incentive to pursue the outcome preferred by the third party (e.g., an uptick in the stock price), but absent a deeper connection, is unlikely to stand in a fiduciary position vis à vis the fund. Under settled principles of agency law, to constitute an agent, the designated director would have to act on behalf of the fund and subject to its control.<sup>149</sup> This suggests a connection that is both broader in scope and more continuous in nature than a mere bonus arrangement. In fact, this is a key distinction between director candidates who are recruited from outside the fund (pursuant to a golden leash) and those appointed from inside the fund, who indisputably owe a duty to the fund.<sup>150</sup> Absent a conflicting interest in a particular transaction,<sup>151</sup> the argument that her she owes genuinely conflicting duties of loyalty is weak.

Even in the absence of a classic fiduciary relationship running between the designated directors and their fund, however, the leash may yet create a conflict of interest. The leash could conceivably give rise to a situation in which a director stands to receive a significant payout for preferring a plan not maximally advantageous to shareholders. The key questions flowing from such a determination would be similar where the designated director has a substantial interest in driving a particular event: “To whom is [the person] a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?”<sup>152</sup> The first place to look for answers to these questions is in the structure of the leash. For example, if a leashed director stands to receive \$10 million in incentive pay in the event that a definitive merger agreement for the company is signed within one year of her joining the board, but only half that amount if it is signed in a subse-

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148. RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. e.

149. *See id.* § 1.01 cmt. c.

150. *See* Laster & Zeberkiewicz, *supra* note 4, at 49 (noting that some designated directors “are often dual fiduciaries who also owe a duty of loyalty” to their nominating entities). Of course, designated directors who are not fund principals may feel some sense of loyalty to the fund owing to its having nominated them, but presumably that is no more disqualifying than a company-nominated director’s predisposition to supporting management initiatives for the same reason.

151. For example, a sale of a major corporate asset to an entity in which a designated director has a major interest.

152. *SEC v. Chenery Corp.*, 318 U.S. 80, 86 (1943).

quent year, then her vote for a transaction within that one-year window could justifiably receive additional scrutiny.

This concern sounds in core values of agency law, and as such cannot be fully countered by economic justifications of the golden leash. The incentives created by the golden leash can be fairly located adjacent to (if not under) the big tent of “fiduciary law.”<sup>153</sup> Yet the fact of overlap with fiduciary-like duties of loyalty hardly constitutes a categorical objection to the leash itself. When distilled to concerns about overlapping loyalties rather than an impermissible investment horizon, the fundamental character of the challenge posed by the golden leash changes as well. Once demystified, it can be mediated by adapting tested disciplinary mechanisms and disclosure obligations from fiduciary and agency law.

#### A. Recent Delaware Cases Relevant to the Golden Leash and the Fiduciary Duty of Loyalty

Delaware cases on the golden leash are part of a large jurisprudence interpreting allegations of multiple loyalties. A key place where such conflicts arise is in the parent-subsidary context. The facts of *Weinberger v. UOP, Inc.*,<sup>154</sup> for example, illustrate the problem. In that seminal case, directors held overlapping duties to two entities by virtue of the fact that they sat on the boards of both a corporation and its subsidiary. Plaintiffs alleged that the dual-seated directors engineered a transaction that favored the parent’s interests over those of the subsidiary,<sup>155</sup> much as critics of the golden leash today allege that designated directors favor their nominating fund’s interests over that of the company and its shareholders. The outcome and rationale in *Weinberger* provides helpful principles for adjudicating the leash phenomenon: the court declined to hold that dual-seated directors were per se conflicted but found an “absence of any attempt to structure [the] transaction on an arm’s length basis” and on that basis held the directors conflicted.<sup>156</sup>

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153. The reach of fiduciary law has grown substantially, with some scholars applying fiduciary principles to public law. See, e.g., Gary Lawson & Guy I. Seidman, *By Any Other Name: Rational Basis Inquiry and the Federal Government’s Fiduciary Duty of Care* (Boston Univ. Sch. of Law Pub. Law & Legal Theory, Working Paper No. 16–29, 2016), <https://www.bu.edu/law/files/2016/08/dutyofcareclean.pdf> [<https://perma.cc/KRK5-SGFW>]. The debate over the proper scope of fiduciary law has attracted considerable scholarly attention. See, e.g., Tamar Frankel, *Fiduciary Law in the Twenty-First Century*, 91 B.U.L. REV. 1289, 1289–90 (2011).

154. 457 A.2d 701, 710 (Del. 1983).

155. *Id.* at 703.

156. *Id.* at 710.

*In re PLX Technology*<sup>157</sup> and *In re Zale Corp. Stockholders Litigation*<sup>158</sup> call for the same essential inquiry: do the facts suggest a conflict of interest? In both cases, designated directors were alleged to have a golden leash-type of arrangement that boosted their compensation upon the accomplishment of certain objectives (sales of the company or major assets). These opinions can be seen as an extension of lines of cases alternately rebuking corporate boards<sup>159</sup> and designated directors<sup>160</sup> for abusing the levers of corporate governance. They also extend to the activist hedge fund context an important dialogue about the potential for conflict among fiduciary duties owed to multiple entities.<sup>161</sup>

The judges in *PLX* and *Zale* were presented with motions to dismiss a claim that designated directors were biased in favor of their nominating funds' interests. They faced similar facts but reached opposite holdings. Since each case involved the sale of a company, the board was obligated under well-established Delaware law, namely the *Revlon* decision,<sup>162</sup> to seek the highest price available. *Revlon* review thus became the vehicle for the court's analysis of the possibility of a conflict generated by outside director compensation. The *PLX* court allowed the case to proceed solely on the basis of plaintiffs' bare allegation that the nominating fund had a short-term investment horizon and a golden leash-type arrangement with the designated director. By contrast, *Zale* dismissed a claim on a similar factual record. An examination of the two cases reveals some of the anxieties animating

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157. Transcript of Telephonic Ruling on Defendants' Motions to Dismiss, *supra* note 12.

158. No. 9388-VCP, 2015 WL 5853693 (Del. Ch. Oct. 1, 2015), *amended by* No. 9388-VCP, 2015 WL 6551418 (Del. Ch. Oct. 29, 2015).

159. *See, e.g.*, *Blaustein v. Lord Balt. Capital Corp.*, No. 6685-VCN, 2013 WL 1810956 (Del. Ch. Apr. 30, 2013), *aff'd*, 84 A.3d 954 (Del. 2014); *Intrieri v. Avatex Corp.*, No. 16335-NC, 1998 WL 326608 (Del. Ch. June 12, 1998).

160. *See, e.g.*, *Shocking Techs., Inc. v. Michael*, No. 7164-VCN, 2012 WL 4482838, at \*10 (Del. Ch. Oct. 1, 2012), *vacated on other grounds*, 2015 WL 3455210 (Del. Ch. May 29, 2015). *See generally* *Zauch v. Brody*, No. 15638-NC, 1997 WL 305841, at \*3 (Del. Ch. June 3, 1997) ("[T]he prohibition against inequitable conduct would also apply to a dissident director."), *aff'd*, 697 A.2d 749 (Del. 1997).

161. Both cases also address the adequacy of disclosures made by financial advisors during the sales process, *Deutsche Bank in PLX* and *Merrill Lynch in Zale*, and that part of their analysis has attracted considerable attention. The *Zale* court granted reargument to Merrill Lynch with respect to its holding on financial advisor conflicts in the wake of a decision of the Delaware Supreme Court the day after its original decision, but showed no sign of revisiting the golden leash aspect of the case. *See Zale*, 2015 WL 6551418.

162. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (explaining that where circumstances indicate that the sale or breakup of a company is inevitable, the fiduciary obligation of the target's board of directors is narrowed to pursuing the highest possible price).



hostility to the golden leash and suggests a need for greater focus on the fiduciary duty dimension rather than differences in investment horizon.<sup>163</sup>

### 1. *In Re PLX Technology Inc. Stockholders Litigation*

*PLX* concerned the campaign of Potomac Capital Partners, an activist hedge fund, to join the board and agitate for a sale of PLX Technology, Inc. Eric Singer, a co-managing member of Potomac who served on the PLX board, led the fund's efforts to force a sale of the company.<sup>164</sup> The lawsuit alleged that Singer, by virtue of his connection to the fund, was pursuing an investment horizon that conflicted with the best interests of the company. Since the allegation concerned a sale of the company, the court applied the enhanced scrutiny standard of *Revlon* rather than the more deferential business judgment rule. Singer moved to dismiss. In a transcript ruling,<sup>165</sup> Vice Chancellor J. Travis Laster denied Singer's motion, citing allegations that Singer had a golden leash and allowing the suit to proceed. Singer "was getting paid for a near-term event," the opinion stated, and "he had an incentive to pursue a near-term event in a manner that other directors did not."<sup>166</sup>

The court's willingness to greenlight a claim of a breach of fiduciary duty notwithstanding an impoverished factual record on that point suggests an intense hostility towards activist compensation of directors. Given the case's posture (a motion to dismiss), the court was obligated to treat the plaintiffs' allegations as true. However, the evidence that Singer even had a golden leash arrangement was thin to nonexistent.<sup>167</sup> There was no evidence that a conflict resulted. The

163. Some observers have argued that corporations must, "as a matter of statutory command, plan for a perpetual future," i.e., they must be "immortal" or seek immortality. Andrew A. Schwartz, *The Perpetual Corporation*, 80 GEO. WASH. L. REV. 764, 766 (2012).

164. Transcript of Telephonic Ruling on Defendants' Motions to Dismiss, *supra* note 12, at 9:12–13.

165. Transcript rulings are fairly common in the Delaware Chancery Court. Somewhat analogous to unpublished decisions in the federal courts but more colloquial in tone, they constitute persuasive authority and allow Delaware judges to "deftly employ[] dictum to clarify uncertainty, regulate prospectively, and respond nimbly to emergent challenges." RESEARCH HANDBOOK ON PARTNERSHIPS, LLCs AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 349 (Robert W. Hillman & Mark J. Loewenstein eds., 2015). They also serve a guild interest in that they result in a body of judicial decisions known best to the local bar and unavailable on Westlaw and LexisNexis. See John Jenkins, *Bench Rulings: Delaware's New Normal?*, DEALLAWYERS.COM (Nov. 11, 2016), <https://www.deallawyers.com/blog/2016/11/bench-rulings-delawares-new-normal.html> [<https://perma.cc/DTX4-PJBE>]; Edward M. McNally, *The Court of Chancery Speaks by Transcript*, DEL. BUS. CT. INSIDER (Sept. 12, 2012), <http://www.morrisjames.com/newsroom-articles-12.html> [<https://perma.cc/4XF5-N5M5>].

166. Transcript of Telephonic Ruling on Defendants' Motions to Dismiss, *supra* note 12, at 30:3–9.

167. Singer was a principal of his nominating fund, so the arrangement would not have been structured as a golden leash—which, after all, is compensation given by a fund to a third party—anyway. The court was concerned about the more general risk that, because of his fund's low basis, Singer and the fund would have been willing to accept a suboptimal sale price.

solicitousness extended the plaintiffs' legal theory suggests that, in Vice Chancellor Laster's courtroom and perhaps others, a bare allegation of a golden leash may be sufficient to trigger discovery in the context of a challenged transaction. Given the slow pace and high cost of discovery and the increased risk of a trial implied by a denial of a motion to dismiss, the *PLX* ruling may prove to be a deterrent to expanding the use of the golden leash. A brief review of the facts shows that the court has in effect established an elevated form of scrutiny where the existence of a golden leash arrangement is alleged.

Potomac launched what became a proxy contest for board representation at PLX in early 2013. In a series of volleys, it disclosed that it had accumulated 5.1 percent of PLX's common stock,<sup>168</sup> called on the board to sell the company, and released letters it had sent the board criticizing the company's performance.<sup>169</sup> In the midst of this campaign, a PLX competitor, Avago Technologies, indicated it would be interested in buying the company for \$6 per share.<sup>170</sup> This would have given Potomac, which had bought in at a low basis,<sup>171</sup> a handsome profit, and it would have delivered similar benefits for PLX shareholders at large, since the company's stock rocketed up by 18 percent during the period in which Potomac announced its stake.<sup>172</sup> The incumbent independent directors, however, did not own a significant piece of the company; only two of PLX's six independent directors owned any common stock, and together they owned less than 1 percent of the company.<sup>173</sup> The board rejected the Avago offer, which it said "substantially" undervalued the company," and demanded no less than \$7 per share.<sup>174</sup>

In the months that followed, an adversarial campaign unfolded. Potomac intensified its efforts to cause PLX to sell; the board dug in. Potomac demanded to inspect the company's books and records, publicly called into question the board's competence, threatened litigation, and threatened a proxy contest, all

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168. Acquisitions exceeding 5 percent of a publicly traded company's outstanding stock must be reported within ten days of the event by the filing of a beneficial ownership report, normally a Schedule 13D (or a 13G, where the filer is a passive investor that owns between 5 percent and 20 percent of the company). See 17 C.F.R. § 240.13d-1 (2016).

169. Transcript of Telephonic Ruling on Defendants' Motions to Dismiss, *supra* note 12, at 9:3–12.

170. *Id.* at 9:14–17.

171. Potomac had acquired its stake at prices ranging from \$3.46 to \$4.55 per share. *Id.* at 9:6–7.

172. See Frank Partnoy, Opinion, *The Surprising Market Response to Activist Hedge Funds*, WALL STREET J. (Apr. 22, 2015, 7:01 PM), <http://www.wsj.com/articles/the-surprising-market-response-to-activist-hedge-funds-1429743683> (reporting the figure for the twenty-one day window before and after the announcement of Potomac's stake in PLX).

173. Verified Amended Complaint for Breach of Fiduciary Duty at 21, *In re PLX Tech. Inc. S'holders Litig.*, No. 9880-VCL (Del. Ch. Nov. 7, 2014). These allegations were made by PLX in a letter to the board publicly disclosed on October 25, 2013. *Id.* at 19–21.

174. Transcript of Telephonic Ruling on Defendants' Motions to Dismiss, *supra* note 12, at 9:17–22.

while raising its stake to 9.4 percent of PLX's stock.<sup>175</sup> In a public letter, Potomac criticized the directors for holding only small investments in the company: "[w]ith no real investment dollars at risk, we are concerned that the Board's interests may not be aligned with stockholders."<sup>176</sup> The fund also accused the directors, who had an average tenure of more than fourteen years on the board, of being "more focused on self-preservation" than company value.<sup>177</sup>

The board's choice of response betrayed larger anxieties around short-termism, which later proved influential in Vice Chancellor Laster's court. It alleged that "*Potomac Capital is a self-interested activist investor that is focused on short-term gains at the expense of other PLX Technology stockholders.*"<sup>178</sup> The board accused the fund of trying "to force a quick sale of the Company in order to realize a short-term gain on its investment, to fulfill the demands of its own investors, and to transition capital to its next target, without regard for the best interests of all PLX Technology stockholders."<sup>179</sup>

The board thus claimed it feared Potomac was intent on engineering "a quick fire sale" that would benefit the fund while hurting other shareholders. While the board called these goals "transparent,"<sup>180</sup> it cited no evidence of them. It did hire a corporate private investigator to research Potomac, which turned around and advised the board of what plaintiffs called the fund's "history of successful 'pump and dump' tactics."<sup>181</sup> In other words, the investigator paid by the board repeated back to the board the board's own allegations. It is not uncommon for such an investigator to confirm the suspicions of the party that hired him or her, but what should have raised a red flag for the court is that the investigator apparently provided no new factual support for the board's allegations of corruption.

175. *Id.* at 9:23–10:10:3; Verified Amended Complaint for Breach of Fiduciary Duty at 14, *supra* note 173.

176. Verified Amended Complaint for Breach of Fiduciary Duty at 21, *supra* note 173 (italics in original, bold emphasis omitted).

177. *Id.*

178. *Id.* (italics in original, bold emphasis omitted).

179. *Id.* at 21–22. The board explained its reason for opposing Potomac's actions:

- "We believe [Singer's] intent is to control and cow the board into driving to a quick sale for the sole benefit of Potomac." *Id.* at 22.
- "Our concern is that Singer's goal is effectively take control of the board so he can make a quick transaction that benefits his fund, even if it is at the expense of other shareholders." *Id.*
- "We do not believe Potomac's actions are those of a stockholder working to enhance value for all other investors." *Id.*
- Potomac is "an activist hedge fund with a relatively short-term horizon." Transcript of Telephonic Ruling on Defendants' Motions to Dismiss, *supra* note 12, at 10:6–7.

180. Verified Amended Complaint for Breach of Fiduciary Duty, *supra* note 173, at 21 (quoting statements of the board).

181. *Id.*; see also Transcript of Telephonic Ruling on Defendants' Motions to Dismiss, *supra* note 12, at 10:3–4.

Following this battle, Potomac's nominees were elected by PLX shareholders, Singer became chair of the sale committee,<sup>182</sup> and the company was ultimately sold to Avago for a price of \$6.50 per share.<sup>183</sup> Far from dismissing this ceremonial documentation exercise, Vice Chancellor Laster twice emphasized the role of the investigator's report in shaping the views of the board.<sup>184</sup> The import of the investigator's report appears to have been greater for the court than for the plaintiffs, who scarcely mentioned it in the complaint or in their opposition to Singer's motion to dismiss.

The presence of a golden leash-type of arrangement should not have been cause for assuming Singer was disloyal to the company. In fact, the opposite conclusion might have been appropriate: Potomac's large stake aligned the incentives of the fund (and Singer) with those of PLX's shareholders at large, since a higher stock price benefited all.<sup>185</sup> Indeed, this alignment of interests is presumed as a matter of law in Delaware, since shareholders "act to maximize the value of their own investments."<sup>186</sup> Vice Chancellor Laster ruled, however, that the presumption of alignment had been rebutted.<sup>187</sup> Citing the private investigator's allegations, the board's statements in the proxy fight, and conjecture about Singer's incentives as a principal of an activist hedge fund—all very thin evidence, and substantially repetitive—the court held that Singer was conflicted.<sup>188</sup>

The court expressed open skepticism about designated directors. It emphasized that its decision was not based on the structure of Singer's compensation (the specifics of which it did not know) but on the class of shareholder of which he is a type. "[P]articular types of investors may espouse short-term investment strategies and structure their affairs to benefit economically from those strategies,"<sup>189</sup> the

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182. Transcript of Telephonic Ruling on Defendants' Motions to Dismiss, *supra* note 12, at 15:8–9, 15:17–18.

183. Anna Prior, *Avago Technologies to Acquire PLX Technology*, WALL STREET J. (June 23, 2014, 6:36 AM), <http://www.wsj.com/articles/avago-technologies-to-acquire-plx-technology-1403519773>.

184. See Transcript of Telephonic Ruling on Defendants' Motions to Dismiss, *supra* note 12, at 10:4–15, 28:17–22.

185. *Id.* at 26:3–21.

186. *Katell v. Morgan Stanley Grp., Inc.*, No. 12343, 1995 WL 376952, at \*12 (Del. Ch. June 15, 1995) (citing *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1380–81 (Del. 1995)).

187. See Transcript of Telephonic Ruling on Defendants' Motions to Dismiss, *supra* note 12, at 28:17; 29:20–30:2 ("[T]he board believed and represented that Potomac was a short-term investor that had a disparate investment horizon, was trying to get a short-term sale event from which it would benefit primarily from its low basis, and that it had interests that were different from those of the stockholders as a whole.").

188. Although Vice Chancellor Laster leveled some criticism at the sales process, his holding was based on Singer's alleged conflict, not the process itself. See, e.g., *id.* at 18:5–14 (expressing puzzlement at the board's failure to follow up on expressions of interest from potential acquirers that indicated higher prices than Avago's offer).

189. *Id.* at 27:6–9.

court stated, suggesting that Singer might have been such a “type[] of investor” because he was unduly influenced by a desire for short-term liquidity—a preference for some cash now over more cash later.<sup>190</sup> The court tied this into a broader worry about short-termism, quoting scholarship referring to such shareholders as “impatient” and citing three articles written by Delaware Chief Justice Leo Strine warning of “the potential short-term interests of hedge funds.”<sup>191</sup> Beyond gesturing at these themes and the benefits of liquidity in general (which would also appeal to ordinary shareholders, of course), the court offered no explanation as to why Potomac’s strategic priority would be different from that of shareholders as a whole, i.e., to sell the company for the highest price. It invoked Singer’s relationship to the fund, calling it a golden leash:

[T]o the extent—and he did—Singer had fiduciary duties to his fund or was otherwise compensated and received returns from his fund, his interest was like a golden leash agreement. He was getting paid for a near-term event, and he had an incentive to pursue a near-term event in a manner that other directors did not.<sup>192</sup>

This comment, too, reflected naked speculation; no evidence beyond the private investigator’s report had been offered regarding how Singer would or even could benefit from causing a “near-term event,” like the sale of the company, in a way that ordinary shareholders would not. Yet the court concluded that Singer operated “as a dual fiduciary who owes competing duties to a stockholder with conflicting interests,” and thus “cannot be considered as disinterested or independent.”<sup>193</sup> It held that the factual allegations were sufficient at the motion to dismiss stage to green light the claim that he had breached his duty of loyalty or good faith.<sup>194</sup>

In reaching his holding, Vice Chancellor Laster took pains to emphasize that he was “not saying that there is some bright-line rule here”<sup>195</sup> that would prohibit activist-appointed directors from serving on boards. Given the absence of evidence supporting the theory that Singer or Potomac had a conflict, however, it is hard to give the holding the narrow reading the court urged.

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190. *Id.* at 27:1–5 (“Liquidity may lead directors to breach their fiduciary duties and stockholder directors may have been found to breach their duty of loyalty if the desire to gain liquidity causes them to manipulate a sales process.”).

191. *Id.* at 27:12–28:6.

192. *Id.* at 30:3–9.

193. *Id.* at 30:18–21.

194. *Id.* at 30:21–24.

195. *Id.* at 42:17–18.

## 2. *In Re Zale Corporation Stockholders Litigation*

Like the *PLX* case, *Zale* involved a fund that agitated for the sale of a jewelry company of which it was a major shareholder and in which it had board representation. The facts of *Zale* were similar to *PLX* in two key respects. First, as in *PLX*, the fund in *Zale*, Golden Gate Capital, had designated directors serving on the company's board.<sup>196</sup> Second, the plaintiffs alleged that the fund had "an exigent need for liquidity"<sup>197</sup> that compromised the judgment of its designated directors in approving a sale of *Zale*, i.e., they were willing to accept a lower price than the company could fetch in a fast-tracked sale process because they needed cash fast. As evidence of Golden Gate's need for liquidity, it was claimed that Golden Gate had considered conducting a secondary offering of shares to raise money.<sup>198</sup> This claimed preference for liquidity over value maximization supposedly distinguished the designated directors' interests from those of shareholders at large<sup>199</sup> (who presumably also understood the time value of money, i.e., that a dollar today is preferable to a dollar next month).

Though the liquidity argument was a weak one, additional facts in *Zale* supported an even stronger inference of a conflict of interest between fund and company than in *PLX*. Golden Gate was a far more significant shareholder than Potomac of its target, owning nearly 25 percent of the jeweler.<sup>200</sup> In addition, Golden Gate had a \$150 million loan outstanding to the company through which it received warrants for a further 25 percent of its common stock.<sup>201</sup>

The judge in *Zale*, Vice Chancellor Donald Parsons, assumed for purposes of the motion that the designated directors owed fiduciary duties to Golden Gate, as its employees and representatives on the board.<sup>202</sup> Nevertheless, the court found no conflict of interest, holding that the fund's interests and those of the company's shareholders were aligned.<sup>203</sup> The opinion rejected the allegation that the fund received "unique, material benefits in the form of liquidity"<sup>204</sup> by selling the company, noting that the plaintiffs never offered evidence beyond

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196. Two senior Golden Gate employees served as directors on the *Zale* board. See *In re Zale Corp. Stockholders Litig.*, No. 9388-VCP, 2015 WL 5853693 at \*1 (Del. Ch. Oct. 1, 2015).

197. *Id.* at \*9.

198. *Id.* at \*2–3.

199. *Id.* at \*17.

200. *Id.* at \*1.

201. *Id.*

202. *Id.* at \*13.

203. *Id.* at \*15 ("[T]he majority of the Director Defendants' interests were aligned with the rest of *Zale*'s stockholders . . .").

204. *Id.* at \*9.

“conclusory allegations”<sup>205</sup> that Golden Gate wished or needed to liquidate its shares. Besides, the court noted, the fund had other avenues to liquidity, including the secondary offering identified in the plaintiffs’ complaint.<sup>206</sup> The court believed the designated directors, having chosen to pursue a sale, were motivated to seek the highest price possible, which benefited all shareholders.<sup>207</sup> It granted the motion to dismiss.

Here, the *Zale* court alighted on a logical fallacy in the plaintiffs’ allegation that Golden Gate’s eagerness to sell rendered its nominees conflicted. If the fund wanted to sell not to boost liquidity but to turn a higher profit than it could through a secondary offering, then it would presumably want the highest price possible. “In that case, Golden Gate’s interests would be aligned with *Zale*’s other stockholders and there would be no reason” for it to accept a below-market offer.<sup>208</sup> “On the contrary, because of its significant stake in *Zale*, Golden Gate likely had as much of an incentive to maximize the value of its investment as any stockholder, rather than take a price cut for the sake of liquidity.”<sup>209</sup> Accordingly, the court held that even if Golden Gate’s designated directors were nothing more than stooges of the fund, there was no conflict between the fund’s objectives and those of the ordinary *Zale* shareholder.

This last finding is critical: the court approached the inquiry with a view to identifying specific areas where interests conflicted, rather than merely areas where a second entity might have a non-conflicting claim on the designated directors’ loyalty. Convergent or consistent interests by definition pose no conflict.

## B. Situating *PLX* and *Zale* in Delaware Case Law on the Duty of Loyalty

From the standpoint of identifying duty of loyalty conflicts, the material facts in *PLX* and *Zale* are indistinguishable. In each case, designated directors employed by a fund successfully pushed for a sale of the company and plaintiffs sued alleging a conflict of interest stemming from a desire for liquidity. In neither case did plaintiff present evidence of a preference for liquidity, let alone evidence that such a preference would harm the average shareholder of the company.

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205. *Id.* at \*9. The plaintiffs’ primary evidence that the fund had urgent liquidity needs was that prior to agitating for a sale of the whole company, the fund had sought to liquidate its position via a secondary offering of its shares. *See id.* at \*9. In the court’s view, the very existence of this alternative undermined the plaintiffs’ claim: If the fund were truly “parched for liquidity, it could have proceeded with the [s]econdary [o]ffering that it already had initiated rather than undergoing a lengthy merger process.” *Id.* at \*18.

206. *Id.*

207. *Id.*

208. *Id.*

209. *Id.* at \*13.

There are surface differences in facts, of course. For example, the plaintiffs' claim in *PLX* was rhetorically corroborated by the report of a private investigator stating that the fund subscribed to a short-horizon investment strategy. However, this exercise did not generate what would normally be considered evidence (as opposed to allegations) of a conflict for purposes of surviving a motion to dismiss.

In *Zale*, the fund's ready access to an alternative path to liquidity besides a sale of the company seemed to undermine the plaintiff's claim that the fund prioritized liquidity about all else. However, in *PLX*, there was no evidence of a need or preference for liquidity whatsoever. And then there is the vastly greater influence the fund in *Zale* exercised over the company as compared with the fund in *PLX*, which created a correspondingly greater theoretical possibility that minority shareholders would be taken advantage of in *Zale*. Yet the *Zale* court found no conflict and the *PLX* court ordered discovery on the point, based on an assumption of a golden leash. The two holdings are irreconcilable.

Though *PLX* and *Zale* reached opposite outcomes, what unites their analysis is that each judge thought it necessary to probe the fund's motivations concerning investment horizon. Usually, the activity triggering suspicion is far more pernicious than a possible difference in investment horizon.

Two other Delaware cases demonstrate legitimate concerns concerning fiduciary duties that might otherwise be characterized as angst over investment horizon. In the first, *Shocking Technologies, Inc. v. Michael*,<sup>210</sup> the court addressed a disagreement on the board over key transactions. A difference in investment horizon was involved: a designated director prioritized his purportedly long-term objectives over the company's near-term goals. But his offensive conduct extended beyond the choice of a different investment horizon. He interfered with the company's near-term efforts to raise capital by revealing damaging, confidential information to a potential investor.<sup>211</sup> In other words, he committed corporate sabotage. The court declared this conduct a violation of the director's duty of loyalty.<sup>212</sup>

A second prominent case in this area, *In re Trados Inc. Shareholder Litigation*,<sup>213</sup> discussed in more detail in Part IV.B.1, likewise concerned not merely a difference in investment horizon but strong evidence of pernicious conduct—self-dealing by the company's board. In connection with a merger, the board

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210. *Shocking Techs., Inc. v. Michael*, No. 7164-VCN, 2012 WL 4482838 (Del. Ch. Oct. 1, 2012), *rev'd on other grounds*, 2015 WL 3455210 (Del. Ch. May 29, 2015).

211. *See id.* at \*9–12 (concluding that the designated director's inappropriate release of information was an elaborate strategy designed to enhance the potential investor's bargaining power and thus enhance the director's own ability to push through governance changes).

212. *Id.* at \*11–12 (declining to award damages on the grounds that the plaintiff had not proved causation).

213. 73 A.3d 17 (Del. Ch. 2013).



adopted an incentive plan under which management was paid for “achieving a sale even if the transaction yielded nothing for the common stock.”<sup>214</sup> The court held that allegations of self-dealing disqualified the transaction from *Revlon* treatment and triggered the application of entire fairness review, the most onerous standard.<sup>215</sup> As in *Shocking Technologies*, the facts of *Trados* are far more suggestive of a conflict of interest than the cases involving the golden leash.

*Shocking Technologies*, *Trados*, and *Zale* suggest that the appropriate locus of concern in the context of designated directors is on conflicts between the duties such directors owe their nominating funds and the companies on whose boards they serve. The analysis in *PLX*, though directed specifically at conflicts between a designated director and ordinary shareholders over investment horizon, can also be characterized as a concern about loyalties and thus supports this view. Law and market practice from two related realms—the sharing of confidential information by directors and the practice of seating VC fund investors on corporate boards—offers a blueprint for balancing the overlapping and sometimes competing interests of designated directors.

#### IV. PRECEDENT FOR OVERLAPPING DUTIES OF LOYALTY

Critics of activism regard tensions between the golden leash and the fiduciary duty of loyalty as a cancer for corporate governance.<sup>216</sup> In two adjacent areas, however, the market has with little fanfare developed nuanced standards to govern directors’ overlapping duties of loyalty: the practices of (1) designated directors sharing company information with their nominating shareholders; and (2) VC funds nominating directors to the boards of young companies. Formally, their duties of loyalty exist independently and simultaneously; they are undiminished and do not “overlap” or “blend.”<sup>217</sup> However, an examination of market practice and legal norms reveals that these obligations operate more fluidly in reality.

##### A. The Information-Sharing Precedent

As part of the process by which they place an investment and nominate directors to the board of a company, hedge funds, private equity firms, and other

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214. *Id.* at 20.

215. *Id.* at 44–45.

216. *See, e.g.*, Bainbridge, *supra* note 10 (contending that the golden leash should be made “illegal”); Coffee, *supra* note 11 (likening golden leash arrangements to bribery of directors).

217. *See* Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).

funds commonly secure the right to receive confidential information from the designated director.

State law supplies the primary sources regulating board members' fiduciary duties to the corporation. The classic corporate duties are the duties of care and loyalty. This latter duty is understood to implicate a duty of confidentiality. Directors are regarded as fiduciaries who have a "quasi-trustee and agency relationship" to the corporation that creates a duty of loyalty.<sup>218</sup> The crux of the duty, as explained by the Delaware Supreme Court in *Guth v. Loft*, is that "[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests."<sup>219</sup> A director's requests for corporate information are presumed valid notwithstanding any relationship he may have with a particular stockholder.<sup>220</sup> This right of access to company information is "essentially unfettered in nature" and is accompanied by a duty to keep it confidential.<sup>221</sup>

The precise contours of the duty of confidentiality are not well defined,<sup>222</sup> but crucially, the obligation does not require directors to keep all information private. Indeed, the practice of board members sharing confidential company information with outside entities with which they are affiliated is commonplace. These outside entities consist variously of activist hedge funds, parent corporations, VC funds (as discussed *infra*), and institutional investors.<sup>223</sup>

For activists and designated directors, the ability to receive company information is critical. The activist thesis requires it: the fund's expertise may allow it to address management and oversight failures, but to do so effectively, it must

218. See *Schoon v. Smith*, 953 A.2d 196, 206 (Del. 2008); accord MODEL BUS. CORP. ACT § 8.30(a) (AM. BAR ASS'N 2011) ("Each member of the board of directors . . . shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.").

219. *Guth*, 5 A.2d at 510; see also *Schoon*, 953 A.2d at 206 (quoting *Guth*, 5 A.2d at 510).

220. See *Kortüm v. Webasto Sunroofs, Inc.*, 769 A.2d 113, 118 n.11 (Del. Ch. 2000).

221. *Kalisman v. Friedman*, No. 8447-VCL, 2013 WL 1668205, at \*3 (Del. Ch. Apr. 17, 2013) (quoting *Schoon v. Troy Corp.*, No. 1677-N, 2006 WL 1851481, at \*1 n.8 (Del. Ch. June 27, 2006)).

222. Past commentary has noted that court decisions are rare, come mainly from a single jurisdiction (Delaware), and are highly fact-dependent. See, e.g., Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675 (2009); Cyril Moscow, *Director Confidentiality*, 74 L. & CONTEMP. PROBS. 197, 198–201 (2011); Charles Nathan, *Maintaining Board Confidentiality*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 23, 2010), <http://corpgov.law.harvard.edu/2010/01/23/maintaining-board-confidentiality> [https://perma.cc/VA8X-DQHB].

223. Some commentators have suggested that such directors "necessarily" owe a duty of loyalty to nominating shareholders, see Moscow, *supra* note 222, at 206, but the nature and extent of any duty to the shareholder is circumstance-dependent. This distinction comes into play where the designee has no official relationship to the nominating fund, e.g., he is an industry veteran nominated for his expertise and his general agreement with the fund's investment thesis.

receive information freely from the directors it nominated.<sup>224</sup> The result can be greater intra-board friction. In an article, Vice Chancellor Laster has explained the breadth and depth of these disagreements: designated directors “frequently have different views [from management] about matters like the type and degree of information that management should provide, the timeliness of management’s responsiveness, and what issues should be vetted with the board. One person’s monitoring is another’s harassment.”<sup>225</sup>

Information-sharing (or rather, the process by which the activist acquires the information) facilitates this very “monitoring” or “harassment.” Sometimes, the scope of a designated director’s right to share information is limited by a “confi” or confidentiality agreement with the company, but often a confi restricts the use of the information (for example, it may limit further dissemination of the information or trading on it) rather than the sharing itself.

Beyond the potential to annoy incumbent directors, the practice of sharing information outside the company of origin raises the possibility that a conflict will be created between a director’s duties to each entity. Indeed, the act of sharing company information with outsiders could be condemned as a violation of the duty of confidentiality or a legally questionable transfer of property from the company to a third party. It might also be attacked as an impermissible, selective disclosure of protected information in violation of the securities laws.<sup>226</sup> Yet information-sharing has not generated much controversy.

Instead, those most likely to raise such concerns—a company’s other shareholders, regulators, and courts—tend to see the practice as a net positive. So long as certain formalities are respected, these issues are approached pragmatically, based on a case-by-case evaluation of actual and potential conflicts. Notwithstanding some tensions, courts have found ways to safeguard key policy priorities like the protection of minority shareholders. This plays out against a background understanding that absent a direct conflict of interests, arrangements allowing the sharing of information are best for all shareholders and help facilitate capital

224. One indication of the importance of information-sharing to activists is the lengths some boards go to once the activist’s candidates join the board to shield some information from them. This is generally impermissible under Delaware law. See *Kalisman*, 2013 WL 1668205, at \*3 (calling the right of access to company information “essentially unfettered in nature” (quoting *Schoon*, 2006 WL 1851481, at \*1 n.8)).

225. Laster & Zeberkiewicz, *supra* note 4, at 39.

226. The act of selectively disclosing material nonpublic information to an outside investor likely to trade on it may trigger liability under Regulation FD. See 17 C.F.R. § 243.100 (2016). Tippees who take the additional step of actually trading on the information might in turn be liable for insider trading under the “misappropriation theory.” See *United States v. O’Hagan*, 521 U.S. 642 (1997) (holding that an individual may be liable for insider trading where he misappropriates and trades on confidential corporate information in breach of a duty to the source of the information).

formation. A similarly contextual standard should be applied to allegations of director compensation conflicts around the golden leash.

In general, two types of law constrain the disclosure of information by directors outside the company—Delaware fiduciary law and the federal securities laws. Within those sources, a well-tailored (if not formally articulated) exception for certain types of information-sharing can be discerned across the text of various statutes, regulations, and decisional law that allows the sharing of material nonpublic information quite liberally. The rationale offered for this exception in these areas of law and the adjacent areas of trusts and agency law can be extended readily to the area of director compensation conflicts.

### 1. Conflicts and the Duty of Confidentiality

The essence of the duty of loyalty is acting loyally on behalf of the principal. The cases interpreting the duty of confidentiality are directed at protecting that priority. Thus, duty of confidentiality cases focus on monitoring the abuse of corporate information rather than merely any use of the information for non-corporate purposes. A leading case, *Hollinger International, Inc. v. Black*,<sup>227</sup> exemplified this distinction. In *Hollinger*, the Delaware Chancery Court held that a director had violated his duty of loyalty to one entity because he “improperly us[ed] confidential information belonging to [the entity] to advance his own personal interests and not those of [the entity], without authorization from his fellow directors.”<sup>228</sup> *Venoco v. Eson*<sup>229</sup> reached a similar conclusion. Invoking *Guth*, the court in *Venoco* declared that “the law ‘requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest.’”<sup>230</sup> This conception of loyalty is much the same throughout subfields of corporate law.<sup>231</sup>

The fiduciary analysis in cases that police information-sharing prioritizes the interests of the corporation that owns the information. For example, the director cannot deploy confidential information in order to gain leverage in a

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227. 844 A.2d 1022 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005).

228. *Id.* at 1061–62.

229. No. 19506-NC, 2002 WL 1288703 (Del. Ch. June 6, 2002).

230. *Id.* at \*6 (alteration in original) (quoting *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939)); *accord* *Holdgreiwe v. Nostalgia Network, Inc.*, No. 12914, 1993 WL 144604, at \*336 (Del. Ch. Apr. 29, 1993) (noting director was “already under an obligation to maintain the confidences of [the company]”).

231. The prohibition on insider trading, for example, offers a similar formulation. *See, e.g., In re Oracle Corp.*, 867 A.2d 904, 933 (Del. Ch. 2004) (“[I]f a person in a confidential or fiduciary position, in breach of his duty, uses his knowledge to make a profit for himself, he is accountable for such profit.”).

corporate governance dispute, even if he believes in good faith that doing so serves the corporation's best interests.<sup>232</sup> He must instead work through internal processes to persuade his fellow directors of his view. A cousin principle is that the shareholder and any other beneficiaries of his disclosures will be treated as constructive insiders for purposes of insider trading law and generally cannot trade on the information.<sup>233</sup> The emphasis is on preventing not disclosure per se but disclosures that harm the corporation.

## 2. Duty of Confidentiality and Activism

Delaware law has applied this confidentiality analysis to the activism context fairly straightforwardly. Sharing is sanctioned absent a conflict of interest between a designated director's fiduciaries. The Delaware Chancery Court elaborated on these principles in *Kortüm v. Webasto Sunroofs*,<sup>234</sup> which featured a clash between two 50 percent shareholders in Webasto Sunroofs, a joint venture. One of the designated directors sought to exercise his director inspection rights pursuant to Section 220 of the Delaware General Corporation Law<sup>235</sup> to gain access to Webasto corporate information; the other shareholder, believing the designee would turn around and share the information with his nominating stockholder, used his fear of a conflict to justify imposing conditions on the exercise of this right of information-sharing.<sup>236</sup> The court rejected this effort on the grounds that no conflict had been established between the director's roles as a fiduciary of the corporation and of the stockholder.<sup>237</sup> The court explained its conclusion that the designated director's inspection could not be conditioned upon a requirement not to disclose any resulting information to his designating stockholder. Its rationale was that the director is a fiduciary of the company, but also of his designating stockholder. It concluded that "[a]bsent a conflict between those two roles, [the designated director's] fiduciary duty would require him to disclose that

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232. *Shocking Techs., Inc. v. Michael*, No. 7164-VCN, 2012 WL 4482838, at \*9 (Del. Ch. Oct. 1, 2012) *vacated on other grounds*, 2015 WL 3455210 (Del. Ch. May 29, 2015).

233. *See Brophy v. Cities Serv. Co.*, 70 A.2d 5, 8 (Del. Ch. 1949) ("When, therefore, a person in a confidential or fiduciary position, in breach of his duty, uses his knowledge to make a profit for himself, he is accountable for such profit . . ." (internal quotation marks omitted)).

234. 769 A.2d 113 (Del. Ch. 2000).

235. DEL. CODE ANN. tit. § 220(d) (2016) ("Any director shall have the right to examine the corporation's stock ledger, a list of its stockholders and its other books and records for a purpose reasonably related to the director's position as a director.").

236. *Kortüm*, 769 A.2d at 115.

237. *Id.* at 121–23.

information to [the designating stockholder], which is one of [Webasto's] 50% owners."<sup>238</sup>

Noting that the designated director had promised not to disseminate the information recklessly,<sup>239</sup> the court limited the reach of its injunction to a very narrow circumstance—namely, that director's own self-imposed restriction on sharing the information with a competitive entity owned by the stockholder.<sup>240</sup> But, crucially, he was allowed to share the information with the stockholder itself.

Although a director's access to corporate information is "essentially unfettered," such access may be curbed *ex ante* through private ordering. The most common example today is probably the *confi*, often signed by the stockholder as part of an information request or a settlement that results in the designated director being seated on the board.<sup>241</sup> Information-sharing can also be limited by board policy. Such a policy could require a vote to share corporate information with outsiders, for example, on pain of dismissal from the board. This method is still evolving and its limits have not been widely tested. Both models give boards and stockholders options for managing potential conflicts.

### 3. Are Directors Required to Share Information With Outside Affiliates?

The practice of sharing confidential information outside the firm seems like a risk in need of constraint. Company or judicial restrictions on information-sharing, however, might themselves trigger a breach of fiduciary duty. As Vice Chancellor Laster has noted, efforts to curb information-sharing risk creating breaches of fiduciary duty at two levels:

[F]irst at the corporate level by preventing the director representatives from engaging in behavior that is currently a normal part of the investment and monitoring process, and second at the fund level by preventing the director who was a fund fiduciary from sharing information that was material to the fund.<sup>242</sup>

As a general rule, then, a designated director can share information with her affiliate stockholder where (1) the stockholder is not in a position adverse to the corporation and (2) the disclosure to the second fiduciary does not harm the

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238. *Id.* at 121 (emphasis added).

239. *Id.* at 122–23 (noting the director swore an oath, pursuant to his § 220 request, not to violate his fiduciary duty to the corporation).

240. *See id.* at 121.

241. For example, by agreement the directors Third Point nominated to the board of Dow are not allowed to speak to the Third Point fund outside the presence of the board.

242. Laster & Zeberkiewicz, *supra* note 4, at 55.

corporation. This rule sensibly accommodates the practical concerns of the relevant parties and in the process facilitates capital formation, as the VC example more fully illustrates.

### B. The Venture Capital Precedent

A parallel to the golden leash arrangement can be found in the VC ecosystem, where relationships between funds and companies share key features with the activism paradigm. In both cases, funds seek representation on the board of their portfolio companies as a key plank of their strategy to reduce agency costs. Similarly, funds in both cases are constrained by contract or client expectations regarding their investment horizon; hedge funds generally seek to return capital within a few years, and VC funds within seven to ten years, a period made shorter in practice because it includes many activities before and after the investment. Fund-nominated directors in both contexts are often employed by the fund or have incentives to drive the fund's agenda, which creates the possibility of overlapping duties of loyalty, or at least mixed incentives. Further, the fund agenda in both cases is often presumed or claimed to differ in strategy and time horizon from that of ordinary shareholders. Fund-appointed directors often enjoy special rights through preferred stock that activists do not enjoy.

If anything, the fact that funds in the VC world target private companies suggests a heightened potential for conflicts of interest,<sup>243</sup> given the opacity that shrouds venture-backed investments relative to their public-company counterparts. Yet with a few prominent exceptions discussed in this Part, the VC ecosystem has been largely spared the fiduciary duty scrutiny the golden leash has experienced. Rather than suggesting that VC-company overlaps are, or should be, per se invalid, as has been argued with respect to the golden leash, courts have displayed a willingness and competence to conduct the fact-intensive inquiries that are sometimes required.

A number of salient differences exist that could plausibly account for this difference in treatment. One is the collaborative tradition of VC-company relationships as distinguished from the adversarial history of activist-company relationships. To a degree, the lack of scrutiny may also stem from the common assumption that companies benefit strategically from the participation of fund principals on the board as advisors and company cheerleaders. As a matter of law, however, the directors' loyalty obligations to the company are not affected by such

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243. Kevin Roose, *Venture Capital Has a Self-Dealing Problem*, FUSION (Mar. 12, 2015, 12:29 PM), <http://fusion.net/story/102544/venture-capital-has-a-self-dealing-problem> [<https://perma.cc/GB3U-EBF8>].

considerations. In fact, the minimal disclosure obligations of a VC-backed company, combined with the absence of a check by outside investors in that setting, suggests if anything a heightened need to monitor overlapping loyalties in the VC ecosystem compared to public-company activism. At a minimum, the approach applied in the VC context could be adapted to conflicts inquiries caused by the golden leash.

### 1. In Re Trados

In the VC context, courts and commentators tend not to criticize interests and duties that merely overlap, focusing instead on those that create conflicts. *In re Trados, Inc. Shareholder Litigation*<sup>244</sup> is a leading Delaware case on overlapping or blended duties in this area. The case involved a VC's exit from an investment where the funds and directors they appointed held preferred stock in the Trados firm. Ultimately, the VC-appointed directors voted unanimously to sell the company.<sup>245</sup> The preferred stock featured a liquidation preference. The effect of that liquidation preference was that the VC fund and the directors they nominated received millions of dollars—whether directly or through stakes in their funds—from a sale.<sup>246</sup> However, that same liquidation preference seemed likely to deprive holders of common stock of any payment from the sale,<sup>247</sup> and in fact the common stockholders received nothing.<sup>248</sup>

Beyond the liquidation preference, some VC directors in *Trados* were also slated to receive additional pecuniary and reputational benefits, including board membership and employment at the acquirer after closing,<sup>249</sup> that were not available to the common stockholders. Vice Chancellor Laster, who later decided *PLX*, wrote the post-trial opinion in *Trados*. The court explained just how the structure of the VC directors' holdings led to the determination that they were interested in the transaction:

Thus . . . where the interests of the common stockholders diverge from those of the [VC directors who were] preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders. . . . [T]he factual allegations in the Complaint support a reasonable inference that the

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244. 73 A.3d 17 (Del. Ch. 2013); *see also supra* notes 210–212 and accompanying text.

245. *In re Trados Inc. S'holder Litig.*, No. 1512-CC, 2009 WL 2225958, at \*4 (Del. Ch. July 24, 2009).

246. *Id.*

247. *Id.*

248. *Trados*, 73 A.3d at 20.

249. *Trados*, 2009 WL 2225958, at \*4.



interests of the preferred and common stockholders diverged with respect to the decision of whether to pursue the merger.<sup>250</sup>

The court then denied the defendants' motion to dismiss, depriving the transaction of business judgment rule protection.<sup>251</sup> At trial, the defendants had to show the entire fairness of the transaction, Delaware's "most onerous standard."<sup>252</sup> Evidence was presented both showing the extent and nature of the conflict and the role it played in the transaction. The court ultimately held that the transaction satisfied the entire fairness standard (because the common stock had no value for appraisal purposes),<sup>253</sup> but its inquiry was notable for its thoroughness.

The *Trados* litigation has been widely seen as a critique of the way the VC ecosystem handles the duty of loyalty. The decision "explodes standard operating assumptions inherent in the venture capital model."<sup>254</sup> Even though the board's behavior was highly typical and included nothing "that might be characterized as extraordinary or particularly underhanded . . . the court identified several areas of conflicts of interest and unfair dealing."<sup>255</sup> Yet the analysis occurred entirely within the well-established frame of the fiduciary duty of loyalty and did not require speculation regarding presumed differences over investment horizon. By focusing on the allegation that the common shareholders received less money than they otherwise would have, the court demonstrated a sophistication at probing for conflicts of interest in *Trados* that can readily be applied to a golden leash setting.

## 2. Beyond *Trados*

Two more recent cases—*Carsanaro v. Bloodhound Technologies, Inc.*<sup>256</sup> and *In re Nine Systems Corporation*<sup>257</sup>—likewise involved allegations that VC-appointed directors at portfolio companies had abused their positions at the expense of common stockholders. In both cases, the common stockholders learned that their interests had been diluted in earlier financing rounds that had been led by

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250. *Id.* at \*7, partially quoted in *Trados*, 73 A.3d at 42.

251. *Trados*, 73 A.3d at 44–45.

252. *Id.* at 44.

253. *Id.* at 79.

254. *In re Trados: Delaware Court of Chancery Reviews Venture Capital Exit Under Entire Fairness, Faults Board on Process*, PRACTICAL LAW (Aug. 22, 2013), <http://us.practicallaw.com/2-538-8085> [<https://perma.cc/74T9-RZUJ>].

255. *Id.*

256. 65 A.3d 618 (Del. Ch. 2013).

257. No. 3940-VCN, 2014 Del. Ch. LEXIS 171 (Sept. 4, 2014), judgment entered by 2015 Del. Ch. LEXIS 133 (May 7, 2015).

VCs that were represented on the board. The cases provide further support to the proposition that courts have the tools they need to adjudicate conflicts allegations.

*Carsanaro* and *In re Nine Systems* both contained far sharper allegations of conflicting duties of loyalty than were alleged in either *PLX* or *Zale*. In *Carsanaro*, holders of common stock challenged the earlier financing rounds and aspects of the sale itself. Examining the earlier rounds, the court found signs of conflicts and denied the directors' motion to dismiss on the grounds of inadequate disclosure; the parties ultimately settled before a final judgment was rendered. An executive pay plan adopted in connection with the transaction that ate up nearly one-fifth of the total value of the deal (and multiples of the amounts paid to common holders) also attracted criticism from the court. It took over six years of litigation before a judgment was rendered in *In re Nine Systems*, but the court ultimately concluded that the directors had breached their duty of loyalty and ordered them and their funds to pay \$2 million in attorneys' fees to the plaintiffs.<sup>258</sup>

These cases suggest that courts are willing and able to police the porous lines that separate the interests of VC-appointed directors qua directors from their interests as fund principals. But concerns about fiduciary duties can also be prevented through observance of best practices and procedural corporate governance. Law firms and other intermediaries can of course be retained to provide tailored guidance on the subject, and have drafted some written advice to help funds reduce fiduciary frictions. One such guide contained detailed suggestions urging directors of portfolio companies to make reasonable inquiries to detect potential conflicts, for the twin purposes of forestalling litigation and retaining the protection of the business judgment rule.<sup>259</sup>

The challenges presented by the circumstance of a fiduciary wearing two hats are not new, and courts and intermediaries have evolved coherent methods to prevent, mitigate, manage, and remedy conflicts, ex ante and ex post, when they arise. The combined experience of courts and practitioners in this area can be readily applied to dealing with the golden leash. The very title of recent guidance on the subject authored by law firm partners, the "Venture Capital Board Member's Survival Guide: Handling Conflicts Effectively While Wearing Two Hats," arguably suggests the possibility of applying learning in the VC space to

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258. *In re Nine Sys. Corp. S'holders Litig.*, No. 3940-VCN, 2015 Del. Ch. LEXIS 133 (May 7, 2015).

259. JOSHUA G. HAMILTON ET AL., THE VENTURE CAPITAL REPRESENTATIVE DIRECTOR: NAVIGATING THE FIDUCIARY OBLIGATIONS, 2 BLOOMBERG L. REPS. 1 (2009), <https://www.paulhastings.com/docs/default-source/PDFs/venturecapital.pdf> [<https://perma.cc/88BX-V49V>].

the golden leash context.<sup>260</sup> The two areas involve similar synergies and tensions between fund and company interests.

The VC setting is a particular example of courts' experience dealing with overlapping fiduciary duties in an ecosystem that has much in common with activism. However, aspects of the challenge are not limited to either context but arise whenever there is a sale of the company:

The heightened scrutiny that applies in the *Revlon* (and *Unocal*) contexts are, in large measure, rooted in a concern that the board might harbor personal motivations in the sale context that differ from what is best for the corporation and its stockholders. Most traditionally, there is the danger that top corporate managers will resist a sale that might cost them their managerial posts, or prefer a sale to one industry rival rather than another for reasons having more to do with personal ego than with what is best for stockholders.<sup>261</sup>

In sum, the fiduciary duty-related dangers of a golden leash are well known, and so are the mechanisms to manage them. Moreover, courts and intermediaries are experienced at dealing specifically with differences in investment horizon between fund-appointed directors and common stockholders.

## V. REGULATING THE GOLDEN LEASH

The golden leash presents a unique and powerful mechanism for unifying the interests of shareholders and the directors of a corporation. When structured consistently with the duty of loyalty and adequately disclosed to the board and shareholders, this innovation presents a promising opportunity to curb a significant problem—agency costs—inherent in the modern corporate governance model, in which boards are led by independent directors with relatively small interests in the companies they govern. As activism becomes normalized, the golden leash experiment could blossom, though it will require a renewed focus on first principles and some modest shifts in thinking and behavior.

There are at least two preconditions to legitimizing the golden leash and perhaps unlocking its potential.

First, reflexive suspicion of the practice imported from the wars over activism should be replaced with a sober focus on conflicts implicating the fiduciary duty of loyalty. Courts, regulators, and private-sector intermediaries such as law firms

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260. Steven E. Bochner & Amy L. Simmerman, *Venture Capital Board Member's Survival Guide: Handling Conflicts Effectively While Wearing Two Hats*, 41 DEL. J. CORP. L. 1 (2016).

261. *In re Dollar Thrifty S'holder Litig.*, 14 A.3d 573, 597 (Del. Ch. 2010) (footnote omitted).

should apply the practical teachings, doctrines, and rigor they rely on in the contexts of information sharing and the VC ecosystem to adjudicating questions around the golden leash. For example, in the *PLX* case, the court concluded on the basis of bare allegations that the designated director operated “as a dual fiduciary who owes competing duties to a stockholder *with conflicting interests*,” and thus could not be deemed to be “disinterested or independent”<sup>262</sup> in approving the sale of the company. Instead, after acknowledging the overlap in interests the court should have insisted on well-pled evidence—evidence that would suggest a legally cognizable conflict of interest (as opposed to a difference in investing philosophy)—before allowing the suit to proceed. In other words, it should have approached the inquiry as it would when presented with a dispute over information-sharing or the conduct of a board with VC-appointed directors.

There is nothing intrinsically offensive to the values of corporate and fiduciary law about directors, particularly independent directors, espousing differing philosophies or receiving outside compensation. Attention should focus squarely, as it did in *Zale*, on the nature of any alleged conflict. This step may encounter resistance in the Delaware courts as “a significant percentage of the members of the influential Delaware judiciary appear to have joined the long-and-short movement, endorsing the idea that short-term and long-term shareholders have different interests.”<sup>263</sup> As Vice Chancellor Laster’s approach in *Trados* suggests, however, it is eminently doable.

Second, to enable courts and investors to monitor the terms of golden leash arrangements, more robust disclosure of golden leash structures will be needed. The idea of short-termism—that “short-horizon investors will push for policies harmful in the long-term”—will usually be “inconsistent with basic principles of mainstream financial economics”<sup>264</sup> because any changes that are reflected in a higher stock price should also improve the value of the enterprise on a longer horizon. However, this assumes a degree of informational symmetry between boards and ordinary investors that may not exist as to the specifics of golden leash structures. More robust disclosure would enable investors to judge whether a particular golden leash encourages a director to privilege short-term gains in stock price above other priorities. For example, if a golden leash arrangement stands to provide a designated director with a huge payday in the event a definitive agreement to sell the company is reached within one year (but not after), that

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262. Transcript of Telephonic Ruling on Defendants’ Motions to Dismiss, *supra* note 12, at 30:18–21(emphasis added).

263. Anderson, *supra* note 2, at 27.

264. *Id.* at 20.

information would be helpful to know, especially when it comes time for shareholders to vote on the merger.

The current golden leash disclosure regime, to the extent such a thing can be said to exist, is scattershot. There is no “specific requirement under the current US securities rules for the disclosure of (i) compensation arrangements between a board nominee and the nominating shareholder, or (ii) conflicts of interest” that might be expected to result in a contested proxy solicitation.<sup>265</sup> In 2016, NASDAQ adopted a requirement that listed companies disclose such arrangements.<sup>266</sup> Even if such a requirement became universal, it would likely prove challenging to secure effective disclosure given that companies have limited information from funds about the existence or details of any third-party compensation.<sup>267</sup>

Ensuring robust disclosure of golden leash arrangements will probably require new reporting requirements. SEC rules are the logical place to start, and mandates on both companies and funds will likely be necessary. On the fund side, Schedule 14A, which concerns director elections, could be amended to require funds running a proxy contest to report any third-party compensation arrangements that may be in effect.<sup>268</sup> Activists could further be obligated to disclose such arrangements in filings on Schedule 13D, which requires disclosure of active investors’ positions once the shares they beneficially own exceed 5 percent of the issuer’s outstanding stock.<sup>269</sup> One limitation of focusing exclusively

265. See Matteo Tonello, *Activist Hedge Funds, Golden Leashes, and Advance Notice Bylaws*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 7, 2016), <http://corpgov.law.harvard.edu/2016/01/07/activist-hedge-funds-golden-leashes-and-advance-notice-bylaws> [https://perma.cc/9EJ7-W4LK]; see also Notice of Filing of Proposed Rule Change, Exchange Act Release No. 34-77481; File No. SR-NASDAQ-2016-013, at 3 n.5 (Mar. 30, 2016), <https://www.sec.gov/rules/sro/nasdaq/2016/34-77481.pdf> [https://perma.cc/5KU6-FA87] (noting existence of third-party director compensation disclosure requirements across “various provisions of the federal securities laws”).

266. See NASDAQ Stock Market, Proposal of Rule Change (Form 19b-4) (Mar. 15, 2016), [http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2016/SR-NASDAQ-2016-013\\_Resubmission.pdf](http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2016/SR-NASDAQ-2016-013_Resubmission.pdf) [https://perma.cc/HWP6-BCG2].

267. Companies are increasingly soliciting information about the existence and terms of golden leashes via director questionnaires required of all candidates nominated to the board, but at the moment they have wide discretion in whether, when, and how to pursue and disclose such information, unless otherwise subject to disclosure per SEC regulations.

268. There have been suggestions that Item 5(b) of Schedule 14A, which generally requires disclosure of such arrangements, may not capture arrangements not entered into in the year of disclosure. See Avrohom J. Kess & Yafit Cohn, *SEC Approval of Nasdaq Rule Requiring “Golden Leash” Disclosure*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 27, 2016), <http://corpgov.law.harvard.edu/2016/07/27/sec-approval-of-nasdaq-rule-requiring-golden-leash-disclosure> [https://perma.cc/N74P-K9JD].

269. See 17 C.F.R. § 240.13d-1 (2016) (prescribing disclosure requirements for beneficial holders of 5 percent or more of a public company’s stock).

on funds is that they are only subject to these reporting requirements if they undertake certain actions—launching a proxy contest in the case of Schedule 14A,<sup>270</sup> or crossing the ownership threshold that triggers a Schedule 13D reporting duty.<sup>271</sup> This gap can be addressed in part through company-side regulation. For example, the meaning of “material definitive agreements” for purposes of Form 8-K could be expanded.<sup>272</sup> That rule currently requires disclosure of the company’s own material agreements, but could conceivably embrace substantial third-party compensation of directors. Since companies sometimes lack information of this sort, they may find they need to ask about third-party compensation on the questionnaires they require director candidates to complete.

The need for greater disclosure of golden leash arrangements is magnified by the convergence of activist and company goals. Activists and companies have some ability to agree on structures that benefit activists while allowing incumbent directors to keep their jobs, and absent more robust reporting requirements their increasing collaboration may make that more likely and harder to detect. That activist-company disputes are increasingly resolved through settlement rather than proxy contests further amplifies this need: the less adversarial the engagement, the less likely a controversial golden leash structure will be revealed. Whatever the precise contours of a new disclosure regime, there is little doubt that disclosure could be mandated that would give shareholders and courts at least as much information on golden leash structures as they currently receive on information sharing agreements and VC-appointed directors. This would be a well-advised and modest role for Justice Brandeis’s dictum that sunlight is the best disinfectant.<sup>273</sup>

## CONCLUSION

The scholarly and popular debate over short-termism, the golden leash, and shareholder activism is, at bottom, a debate over how best to align company and shareholder interests. The golden leash has great potential to reduce agency costs by improving director fidelity to investor objectives.

At present, the problems with the golden leash are framed superficially as being about investment horizon, i.e., short-termism. If the budding *détente*

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270. *See id.* § 240.14a-101 (prescribing disclosure requirements in connection with the filing of a proxy statement).

271. *See id.* § 240.13d-1.

272. *See* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release Nos. 33-8400 & 34-49424, 83 SEC Docket 1427 (Aug. 23, 2004), <https://www.sec.gov/rules/final/33-8400.htm#seci> [<https://perma.cc/7C2X-EKFH>].

273. LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* 62 (1933) (“Sunlight is said to be the best of disinfectants . . .”).

between activists and companies continues, however, this preoccupation may give way to a more sober discussion over the very real challenge of integrating the golden leash into the existing system of corporate governance and conflicts of interest regulation. Informed by the precedents of information sharing and standard practices in the VC markets, incremental additions to the current disclosure regime could help bring needed legitimacy and transparency to this new structure. These enhancements, in turn, could help activists achieve their potential as sound governance entrepreneurs,<sup>274</sup> which would not only contribute to shareholder welfare but promote consensus-building, dialogue, and other key values of procedural corporate governance.

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274. See Gilson & Gordon, *supra* note 15, at 897.