Activist Compensation of Board Nominees & the Middle Ground Response

Adam Prestidge
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Abstract

Shareholder activism has taken an increasingly high-profile and polarizing role in investing and corporate governance. Moves by shareholder activists, and the policy behind those moves, constantly appear in corporate headlines. One of shareholder activists’ primary methods of enacting changes in companies is to nominate directors to the board, and often those director nominees are highly-compensated by the shareholder activist itself. Some in the corporate world oppose this practice, arguing that it creates a significant conflict of interest and can damage the company in the short term, while others argue that the practice is a necessary tool for investors that may actually lead to a better alignment of interests. Both arguments have strong merit, which is why companies should evaluate director nominee compensation plans on a case-by-case basis, and react to them not with a preemptive prohibition, but with an evaluative middle ground response.
Introduction

a. The Problem

In April of 2013, Agrium, Inc., a Calgary-based agriculture supplier, made corporate headlines when it rejected a slate of directors nominated by Jana Partners LLC, a hedge fund that owned a 7.5% stake in the Canadian business.¹ Prior to the contested vote, Jana used the weight of its stake to publicly argue that Agrium had underperformed its peers by 160% over the last five years, and was badly in need of a strategic shakeup.² As part of this shakeup, Jana proposed five nominees for the board of directors, arguing that they would be more successful at governing the company.³ However, unlike the incumbent board members, Jana promised to pay its nominees handsomely by giving them a direct percentage of Jana’s profit on its entire investment in the company. This had the potential to be many millions more than $200,000 average annual salary that the incumbent board members received.⁴ A public and bitter proxy

³ Id.
fight followed, along with a pushback against the compensation schemes, with shareholders eventually rejecting all of Jana’s nominees.\(^5\) Having failed to elect its nominees, Jana later significantly reduced its stake in the company.\(^6\)

A month later, another hedge fund, Elliot Management Corp., had more success in its activist investment in Hess Energy. Elliot argued that Hess suffered from poor leadership by its board of directors, and proposed five nominees for the board.\(^7\) A four month proxy battle ensued, with Elliot eventually settling and taking three seats.\(^8\) However, like Jana, Elliot also had planned to incentivize its directors by compensating them based on company performance. Hess publicly and vigorously opposed the compensation plan for the director nominees, calling it an unusual

\(^5\) Dummett and Dawson, *supra* note 1 (highlighting the bitterness in the fight, and touching on a prevailing attitude toward activist investors, the article quotes an investment banking advisor to Agrium: “They figured this was another sleepy western Canadian company, and they were a big New York fund who could scare them to get what they wanted. But their activism is totally misplaced here.”).


\(^8\) *Id.*
scheme to pursue a short-term agenda. On the eve of the proxy vote, facing such strong opposition to the pay plan, Elliot’s nominees waived all compensation from Elliot. Hess treated this as a major victory, stating that the compensation withdrawal confirmed that this practice is short-term focused and conflicted.

b. Prohibiting Activist Shareholders from Compensating Director Nominees

Shareholder activism is on the rise, and one of the strategies that both Jana Partners and Elliot Management attempted, and one that has caught on with hedge funds and activist investors generally, is the lucrative compensation of director nominees (referred to in this paper as “sponsor compensation”). Although the practice is relatively young, it has engendered staunch opposition from corporations, academics, and leading corporate law firms.

Wachtell, Lipton, Rosen, and Katz, a leading corporate law firm, has written and touted a model company bylaw that would ban the practice. Several large corporations, including Marathon


11 See discussion in Part V.
Oil, Eastman Chemical, and Halliburton have adopted a similar bylaw prohibiting it.¹² And law professors have captured the animus against it by flatly stating: “If this nonsense is not illegal, it ought to be.”¹³ John C. Coffee, Jr., professor of corporate law at Columbia University, was quoted by Hess in its campaign against Elliot’s director compensation plan, and summarizes the seemingly urgent fight against activists’ director pay: “Today, we are at the crest of an immense slippery slope. If legitimized, these new compensation tactics will likely be used in a broad range of control and proxy fights, with the long-term result being a shift towards greater risk and leverage.”¹⁴

The purpose of this paper is to weigh in on this debate by giving due credit to the solid policy arguments put forth by both sides and by suggesting how corporate boards should react to activist-compensated nominees. Recently, the topic has received significant attention from business news outlets, usually with observers taking firmly opposed positions. However few commentators have attempted to comprehensively discuss the positive and negative policy

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implications of allowing or banning this practice, and even fewer have suggested and described an evaluative middle ground approach, as this paper does.

Part I of this paper will set the context, describing the rise of activist investing, how activists move for changes within corporations, and how their compensation packages are set up for director nominees. Part II will discuss the strong, grounded policy arguments that each side employs in campaigning for or against sponsor compensation. Looking at current data, Part III examines the outcomes from the 2012 and 2013 proxy season to determine how corporate shareholders in general might view this issue. Finally, Part IV makes the argument that when facing activist investors who nominate board members, corporate boards should not adopt a broad ban of sponsor compensation. Instead, they should consider director compensation schemes on a case-by-case basis, through a suggested evaluation framework, and possibly respond with a middle ground defense.

I. Origins of the Problem and Recent Developments

   a. The Broad Rise of Shareholder Activism

Activist investment has become a major force in American corporate governance. Corporate executives and shareholder activists largely expect shareholder activism to increase, with hedge

funds leading the way.\textsuperscript{16} In a survey of over 250 corporate executives and shareholder activists, 52% of respondents expected shareholder activism to somewhat increase over the next year, and an additional 26% expected it to increase significantly. Highlighting the driving force behind activist investment, 74% of respondents expected an increase in activism to come from hedge funds.\textsuperscript{17} However, as an established investment strategy, activism is not limited to hedge funds, with increased activism expected from other major institutional shareholders, including union funds, pension funds, and mutual funds.\textsuperscript{18}

Additionally, although it has first caught hold among U.S. institutional investors, shareholder activism is shifting from an American corporate trend to broad global strategy.\textsuperscript{19} This shift is

\textsuperscript{16} Shareholder Activism Insight 4, SCHULTE ROTH & ZABEL, available at http://www.srz.com/files/News/7cd7d880-c430-4c04-bb31-f12637ae313e/Presentation/NewsAttachment/3c06638e-5702-4720-a1b6-f4b0dd41a46ef/SRZ_2012_Shareholder_Activism_Insight.pdf.

\textsuperscript{17} Id.

\textsuperscript{18} Id.; see also Shareholder Activism and Proxy Contests, GOODWIN PROCTER (May 21, 2013) available at http://www.goodwindirectorsforum.com/wp-content/uploads/2011/03/Final_Shareholder-Activism.pdf.

driven by foreign institutional investors who are demanding the type of returns generated by activism once unique to the U.S.\textsuperscript{20}

Activist investing is also spreading across different industry sectors. The strategy has held a strong foothold in the energy, retail, and technology industries, but recently has expanded to industries that were not previously targets of activist investors, such as banking and finance, which have become more conducive to activist strategies with stabilizing markets.\textsuperscript{21}

Although viewed skeptically by leery corporate boards and those who defend them, some argue that shareholder activism can actually provide an important balance on corporate governance. In the absence of the threat of hostile takeovers, which have declined in frequency since the 1980s, some argue that shareholder activism can check corporate governance and pay practices, and put

\begin{itemize}
\item \textsuperscript{21} William Sweet, \textit{Shareholder Activism in the U.S. Banking Industry}, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, Dec. 3, 2013, \textit{available at} http://blogs.law.harvard.edu/corpgov/2013/12/03/shareholder-activism-in-the-us-banking-industry/#more-55758 (noting that “[t]he relative absence of activist campaigns targeting banking organizations over the last several years may be explained mainly by current market conditions in the industry, which are not conducive to investor expectations for realizing a profit from an activist campaign against a bank.”).
\end{itemize}
pressure on directors to increase stock prices on undervalued stock.\textsuperscript{22} Indeed, underperforming corporations are the most frequent targets of shareholder activism, with activists agitating in companies with weak stock performance, poor growth, or overly-conservative corporate strategy.\textsuperscript{23}

Activist investors employ a varied strategic arsenal to agitate for changes that they believe will make their investment in the company more valuable. To begin, an activist investor, often a hedge fund, will identify a company that it considers to be undervalued or underperforming its peers. It will then acquire a large stake in that company, typically between 5-10\%, large enough to be one of, if not the largest shareholders, but small enough to avoid tripping the corporation’s takeover defenses, such as shareholder rights, or poison pill, plans. Once a major shareholder, the activist has the weight to push for changes in the corporation’s operation and structure in many ways.

\textsuperscript{22} Steven M. Davidoff, \textit{With Fewer Barbarians at the Gate, Companies Face a New Pressure}, N.Y. TIMES, July 30, 2013, \textit{available at} http://dealbook.nytimes.com/2013/07/30/with-fewer-barbarians-at-the-gate-companies-face-new-pressure/; \textit{and} Shareholder Activism Insight, \textit{supra} note 16 (explaining that “[d]uring the financial crisis, activists’ ability to keep management on their toes proved most valuable.”); \textit{see also} David Gelles, \textit{Boardrooms Rethink Tactics to Defang Activist Investors}, N.Y. TIMES, Nov. 11, 2013, \textit{available at} http://dealbook.nytimes.com/2013/11/11/boardrooms-rethink-tactics-to-defang-activist-investors/ (explaining that companies can prepare to defend against activism by assessing and shoring up weaknesses in corporate governance or financials).

\textsuperscript{23} Gelles, \textit{supra} note 19.
One of the primary ways that activists try to convince management and directors to adopt certain policies is by public and legal campaigns. These campaigns create dramatic headlines and attentive media coverage, focusing scrutiny and pressure from across the business world on the corporation.

In April 2013, for example, Greenlight Capital made waves by pressuring vaunted Apple to issue preferred shares and distribute cash from its massive corporate treasury. Over a period of several months, Greenlight released a series of public presentations, press releases, and even filed a lawsuit against Apple to drive the change. Eventually, in response to the pressure, Apple paid out an unprecedented dividend, which Greenlight counted as a major success.

Activists may also forgo the media spotlight of a public campaign and negotiate with management directly. Dan Loeb, CEO of Third Point Capital, is known for his sometimes scathing letters to corporate management, railing at Sotheby’s for failing to rein in spending.


26 Merced, supra, note 24.

pounding Yahoo! for their opposition to his board nomination,\textsuperscript{28} and more gently urging that Sony Corporation spin off one of its major subsidiaries.\textsuperscript{29}

This paper focuses on a third approach: activist investors nominating directors to corporate boards and incentivizing them by paying sponsor compensation. For activists who decide to nominate directors in contested elections, that strategy seems to be working. In 2013, analysts expected to see at least 17 different proxy contests for the election of directors.\textsuperscript{30} In the 2013 proxy season, activists were successful in nearly 70\% of proxy fights, establishing director nomination as not only a force to be reckoned with, but one with a significant chance of victory.\textsuperscript{31}

package that invokes the long-gone era of imperial CEOs: a car allowance, coverage of tax planning costs, and reimbursement for membership fees and dues to elite country clubs.”).


\textsuperscript{31} Goodwin Procter, \textit{supra} note 18.
b. How Nominee Compensation Works in Practice

Compared with the average director compensation, which in 2013 hit a high of $251,000 annually, activist-sponsored directors stand to reap dramatic additional gains. Often, their sponsor compensation is tied entirely to the performance of the company’s stock, directly incentivizing the board nominees to improve the value of the investment owned by their activist sponsor. Compensation plans may be set up a variety of ways, paying directors in direct proportion to the stock value, based on the company’s performance relative to peers, or dependent on achieving certain performance benchmarks. This is unlike traditional directors, who may be paid a much more modest salary by the corporation, and may receive a separate, but relatively small distribution of stocks or securities.

In Elliot Management’s Hess campaign, Elliot proposed five director nominees. Each would be paid a $50,000 retainer by Hess regardless of performance, and would be paid an additional $30,000 for every percentage point the stock price outperformed industry peers, up to a maximum of $9,000,000. As discussed previously, this compensation plan met heavy resistance, perhaps in part from incumbent directors who were opposed to sharing the board with peer directors who could potentially receive up to fifty times more than they would for doing the same job, and the nominees eventually dropped the pay plan.


33 Davidoff, *supra* note 2.

34 See Part III(b).
In Jana Partners’ failed Agrium bid, Jana promised to pay its nominees the same $50,000 retainer. However, unlike Elliot’s compensation plan, the directors’ cut was neither linked to peer performance nor capped at any amount. Instead, the directors would have received 2.6% of Jana’s net profit from its total investment in Agrium shares. Even if not elected, as they were not, the directors were promised 1.8% of Jana’s profit. Jana’s 7.5% stake in Agrium was worth approximately $1 billion at the time, so with strong stock performance, director nominees could have potentially been in line for payouts in the tens of millions of dollars.

Director compensation is not uniform among activists. While Jana and Elliot pay their directors millions of dollars, other funds, such as Pershing Square Capital Management, which has held significant investments in Target Corp, JC Penney and the Canadian Pacific Railway, maintain a strict policy of not compensating director nominees directly, perhaps in part to avoid the distracting debate that comes along with the compensation plan.

Ultimately, most compensation plans fall into one of two categories, either being directly aligned with a performance metric or guaranteed for accepting the nomination. In a presentation to proxy advisers, Jana Partners summarized these two basic alternatives for compensating

35 Davidoff, supra note 2.
36 Id.
37 Id. (noting that Jana’s hefty compensation promise, even to directors who failed to be elected, highlights how difficult it can be for activist investors to recruit potential directors for a contested seat, and why seemingly extravagant compensation is critical to their model).
38 Id.
39 Id.
directors. In the first, a guaranteed compensation plan, “[a]n incentive can be structured to have value no matter how the stock performs, such as by granting a certain amount of stock.”

Unlike compensation plans that only pay a cash amount if the sponsor’s investment increases, directors compensated under the guaranteed compensation plan receive compensation that is inherent in the value of the stock they receive. This structure does align the nominees’ incentives with stock performance to some extent because their stock can increase in value, but it also results in compensation to the director even if the stock value declines, because the director ultimately still owns valuable shares of stock. Jana argues that this would effectively compensate the nominee for simply being nominated, even if the director serves the position poorly.

Alternatively, by tying director compensation directly to the activist’s financial reward itself through stock performance, “[a]n incentive can be structured to only deliver value if the share price appreciates”, which rewards the directors only if shareholders benefit. Under this scheme, if the stock drops and the shareholder activist loses value in its investment, the directors


41 Id. An argument in favor of this model would be that the compensation is not guaranteed for the simple nomination, which firms have certainly offered much more blatantly, but for the service on the board, regardless of the outcome. Nominees could argue that this would free them up to focus on long-term value if it is in the best interest of the corporation, even if it is at the expense of short term profits.

42 Id.
would receive only their initial retainer. But if the stock price increased, the directors would receive a direct cash cut of the shareholder’s profits.

Although the variety of compensation plans may incentivize directors differently, the policy debate among corporations and commentators generally regards them collectively, when in fact, incumbent boards should consider whether the type of compensation could have a significant impact on nominees’ behavior.\(^{43}\)

II. Policy Arguments

Proponents of sponsor compensation include the activists and hedge funds themselves, corporate governance academics such as Harvard Law School’s Lucian Bebchuck,\(^ {44}\) and shareholder services, including ISS Proxy Advisory Services.\(^ {45}\) Opposed to the practice are many major corporations, the lawyers that support them, most notably Martin Lipton, founding partner of

\(^{43}\) See Part IV.

\(^{44}\) Lucian A. Bebchuk, et. al, *The Long-Term Effects of Hedge Fund Activism*, (Columbia Business School Research Paper No. 13-66), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2291577 (presenting a comprehensive empirical investigation of the claim that interventions by activist shareholders have an adverse effect on the long-term interest of companies and their shareholders, and finding that the claim is not supported by the data.)

Wachtell Lipton,\textsuperscript{46} and another contingent of academics.\textsuperscript{47} Both sides advance strong policy points that make it difficult to uniformly accept or reject the practice without disregarding critical aspects of corporate governance.

\textit{a. Policy Arguments In Favor of Sponsor Compensation}

\textit{i. Fiduciary Duties} - Any policy discussion should begin with fiduciary duties, which dominate corporate law. Those observers in favor of sponsor compensation, including directors themselves, note that all directors, including those nominated and handsomely-compensated by hedge funds, are bound by the same traditional fiduciary duties to the corporation and its shareholders. Some director nominees defending the practice have taken it as a point of integrity that once elected, their duty is solely to the corporation and its collective shareholders.

Importantly, Delaware courts have been keenly aware of fiduciary duties with regard to director compensation. Ever the sentinel of corporate governance laws, Delaware courts are yet to see a challenge of sponsored-directors’ ability to satisfy their fiduciary duties. Prevailing case law, however, suggests that if a board’s refusal to allow compensation by activists were motivated by


\textsuperscript{47} See Stephen Bainbridge, \textit{supra} note 13; and see Coffee, \textit{supra} note 14.
a selfish attempt to protect its incumbency, the incumbent board itself could be in breach of its duty of loyalty.\footnote{Blasius Industries, Inc. v. Atlas Corp., 564 A. 2d 651, 658 (1988).}

Part of the reason that even activist-compensated directors are able to fulfill their fiduciary duties is because they owe those duties to both the corporation and its shareholders collectively. The activist investor is obviously a shareholder, so directors can argue that their loyalty to the shareholder activist’s interest is a fulfillment of their duty to shareholders in general. This has led some commentators, noting the growing divide between boards and shareholders,\footnote{James Woolery, \textit{The Challenge for Boards}, \textsc{The Harvard Law School Forum on Corporate Governance and Financial Regulation}, Oct. 24, 2013, \url{available at http://blogs.law.harvard.edu/corpgov/2013/10/24/the-challenge-for-boards/#more-54251}.} to argue that the duty to shareholders and the duty to the corporation should be separated.\footnote{See Simone M. Sepe, \textit{Intruders in the Boardroom: The Case of Constituency Directors}, 91 \textsc{Washington Univ. L.R.} (forthcoming), \url{available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2254982} (arguing that a default rule should be for constituency directors to have an undivided loyalty to shareholders, which would allow them to properly advocate for their sponsors and remove conflicts of loyalty with respect to their duties to the corporation).} But until they are, directors are duty bound to do their best to protect the best interests of both, and must do so regardless of outside compensation.

\textit{ii. Fixed Compensation} – Opponents of sponsor compensation argue that directors who receive special compensation will serve the agendas and special interests of their shareholder sponsors.
But activists and directors are quick to point out that their compensation schemes are fixed, meaning that once directors have been elected, they are no longer beholden to the shareholder to receive that compensation. Their pay is guaranteed according to an external, quantitative metric, regardless of whether the director pursues the shareholder’s agenda. If the director believes that the shareholder’s strategy is in the best interest of the company, he or she may pursue it. But, if in accordance with fiduciary duties, the director believes that another course is preferable, the director can pursue a different strategy. Either way, the director is guaranteed the same outcome-dependent compensation. Under this structure, the director actually has a much greater interest to do what they think will increase the value of the company rather than to simply follow the agenda of an activist.

In Jana’s contest with Agrium, for example, Jana noted that the incentive formula offered to its nominees was “100% formulaic and [had] no discretionary element.” Basically, once the activist has set its incentive scheme in place, and the director has been elected, the director’s compensation is no longer tied to the approval of the activist who compensates the director. Whether the activist approves or disapproves of the director’s decisions, the only factor that determines the director’s compensation is the company’s stock price.

**iii. Better Alignment of Interests** - The interests of activist-compensated directors may actually be better aligned with the company’s performance than other directors who are guaranteed compensation by the corporation. Most corporate directors receive a flat salary, regardless of how the company performs. This creates its own set of concerns, as incumbent directors may be

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51 Davidoff, *supra* note 2.

52 Jana Partners, *supra* note 40.
overly risk averse or unmotivated by the need for growth, and the flat compensation can fail to align the interests of the board with that of the shareholders. In order to properly align directors’ incentives with the shareholders, companies should compensate their outside directors based on company performance.\textsuperscript{53} This gives directors a “shareholding mind-set” and a “personal financial incentive to examine questionable management initiatives with the vigorous, independent, and challenging eye of an owner,” rather than incentivizing them to protect only their seat and their salary.\textsuperscript{54}

Compensating directors with this shareholder-like incentive has become more popular in modern corporate governance.\textsuperscript{55} Without it, boards may run into issues of passivity, and a reluctance to challenge management.\textsuperscript{56} Indeed, empirical research has shown a strong correlation between director stock ownership and more effective monitoring and board performance.\textsuperscript{57}

\textsuperscript{53} Charles M. Elson, Director Compensation and the Management-Captured Board-the History of A Symptom and A Cure, 50 SMU L. Rev. 127, 130 (1996) (stating that “companies should compensate their outside directors primarily in company stock.”).

\textsuperscript{54} \textit{Id.} at 130-31.


\textsuperscript{56} Elson, \textit{supra} note 53, at 132.

\textsuperscript{57} Sanjai Bhagat et. al., \textit{Director Ownership, Corporate Performance, and Management Turnover}, 54 Bus. Law. 885, 891 (1999).
This is exactly how activists are incentivizing their board nominees: in a way that more directly aligns director interests with the interests of the corporation.\textsuperscript{58} By basing compensation on stock performance, sponsored directors are paid only when the entire corporation sees its value increase, which benefits all shareholders, not just activists.\textsuperscript{59}

\textit{iv. Alignment with Shareholder Activist Interests} – Even if sponsored directors are attuned to the interests of their activist sponsors, they actually represent a very important interest in the corporation that may be more closely aligned with the company’s success. First, shareholder activists sometimes invest longer term than many other major institutional investors.\textsuperscript{60} Many are large institutional investors, such as public pension funds, which invest in sectors or indices with little ties to the company itself. Their assets may be adjusted and relocated according to the fund manager’s discretion and timetables, which may sometimes be much shorter than the activists’.\textsuperscript{61}

\textsuperscript{58} An argument could be made that instead of banning shareholder compensation, corporations should take the opposite approach and compensate all of their directors with a similar structure.

\textsuperscript{59} Charles Penner, a partner at Jana, asserts that shareholders recognize the value that sponsored directors bring the board, noting that investors recognize that “it is often necessary to get the best candidates possible and that having actual skin in the game is a good thing.” Gelles, \textit{supra} note 12.


\textsuperscript{61} Recently, institutional investors, such as public pension funds, have begun to use their large investment stakes to influence corporations in ways similar to activist investors. For example,
Second, major institutional investors employ much more capital and will have stakes in a wide range of investments, while activists will spend a much higher percentage of their more limited capital on a major stake in one company.\textsuperscript{62} This makes the activist’s holding in the corporation much more critical, and may thereby lead to more careful risk evaluation by the directors it nominates.

Finally, the directors’ position on the board, or their ownership of stock in the company, may outlast the investment period of the activist itself, and those directors are likely to be more careful not to risk long term stability for short term gains.

\textsuperscript{62} Consider that two large institutional investors, the California State Teachers Retirement System and the New York City pension fund, manage approximately $176 billion and $144 billion in assets, respectively, (\textit{Id.}) while Elliot Management, the largest activist hedge fund discussed in this paper, holds approximately $22 billion under management. (Prequin, \textit{Hedge Funds, The Prequin Quarterly Update, Q3 2013, available at} https://www.preqin.com/docs/quarterly/hf/Preqin_Quarterly_Hedge_Fund_Update_Q3_2013.pdf).
v. Necessary for Hiring Qualified Directors – Finding and hiring highly-qualified directors can frequently be a challenge for corporations. It can be even more difficult for activist shareholders, which is one reason why it is necessary for activists to offer sponsor compensation. Shareholder-sponsored nominees know that they are being hired into a hostile environment and will face opposition from the incumbent directors and the corporation as it tries to resist the activist’s influence, and must be compensated accordingly. Jana Partners notes that unlike directors who are appointed or nominated by the board itself, directors who are hired and nominated by shareholder activists “run the risk of coming under substantial attack by the

63 Brandon S. Gold, Why the Wachtell Bylaw on Director Compensation by Shareholders is Overbroad and May Fail Blasius Scrutiny, THE CLS BLUE SKY BLOG, May 31, 2013, available at http://clsbluesky.law.columbia.edu/2013/05/31/why-the-wachtell-bylaw-on-director-compensation-by-shareholders-is-overbroad-and-may-fail-blasius-scrutiny/; but see John C. Coffee, Jr., The Wachtell Bylaw: A Balanced Perspective, THE CLS BLUE SKY BLOG, May 31, 2013, available at http://clsbluesky.law.columbia.edu/2013/05/31/the-wachtell-bylaw-a-balanced-perspective/ (arguing in response that director compensation as a whole has “increased enormously over the last few years” and pointing out that the nominees at Hess waived their sponsor compensation and were still willing to serve on the board. Coffee further points out that even if nominees are viewed as being aligned with activists, there are enough insurgent elections each year that the directors would be able to find another opportunity.).

company (e.g., being publicly and falsely accused of riding in on a Trojan Horse or wearing a golden leash or being a pain).”\textsuperscript{65} In addition, once aligning with an activist, those nominees are less likely to be asked to join the boards of other corporations, and are generally committing to a potentially long and often difficult process.\textsuperscript{66} In order to convince highly-qualified professionals to take on such a targeted position, activists must promise them heady compensation.

Corporations have leveraged this need in an attempt to defend against activist nominees. When Halliburton passed a bylaw prohibiting sponsor compensation for directors, it did so recognizing that the bylaw would make it more difficult for activists to hire good directors, and would thereby make the corporation more resistant to activist efforts, because activists would be unable to nominate strong candidates.\textsuperscript{67}

But this “bar-the-door” approach may harm corporations in the long run. Shareholder activism is an established investment approach, and activists will continue to nominate and sometimes elect directors regardless of whether they are compensated by sponsors or not. Though the process may be more difficult, eventually some of those nominees will be elected onto boards, and if they are not sponsor-compensated, they may not be the most-qualified. If a company bans sponsor compensation for the most qualified nominees, it may be weakening its own board by forcing the shareholder to nominate less-qualified directors, which ultimately hurts the company.

\textit{b. Policy Arguments Against Sponsor Compensation}

\textsuperscript{65} Jana Partners, \textit{supra} note 40.

\textsuperscript{66} \textit{Id.}

\textsuperscript{67} Davidoff, \textit{supra} note 22.
i. Directors have Unavoidable Loyalty to the Activist – Regardless of the fact that activist-nominated directors are bound by fiduciary duties, they cannot be considered completely independent. They are hired, nominated, and championed by the one shareholder who eventually writes their checks. When directors receive almost all of the benefit of their position from one source, it is unlikely that they will be able to completely separate their opinion from the goals of the activist sponsor. Corporations should be concerned when a director values the interest of one shareholder above others. Although corporate law has generally interpreted the director’s fiduciary duties as being owed to the common shareholders, “it is not entirely clear how ‘constituency’ directors should act when the constituency's interests diverge from the corporation's interests.” For example, if a director knows that his or her activist sponsor would reap faster gains through a particular strategy, it is unclear how the director should consider that strategy if the long term outcome for all other shareholders is less certain. It is likewise unclear


69 Michael K. Molitor, The Crucial Role of the Nominating Committee: Re-Inventing Nominating Committees in the Aftermath of Shareholder Access to the Proxy, 11 U.C. Davis Bus. L.J. 97, 148 (2010) (also noting that “[w]hile it is true that the constituency director will not breach his fiduciary duties to the corporation if he acts in accordance with the corporation's interest (despite whatever anger this may generate among his constituency), what is not clear is whether he would breach his duties to the corporation if he votes in accordance with the constituency's interest when it is in conflict with the corporation's long-term interests.”).
whether serving the interest of one shareholder would be considered to satisfy the obligation to all shareholders.

Not only does this create a potential conflict between the interests of the activist shareholder and those of the corporation, but it also creates conflict between the interests and power of other shareholders. 70 Two different shareholders could prefer two different strategies, and constituent representation of those shareholders on the board could lead to serious conflict and compromised decisions regarding company action. Even if the conflict between shareholders could be marginalized or reduced, the director’s conflicted duty cannot be set aside because corporate law “requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest.” 71

Ultimately, the issue of whether, and how, an activist-compensated director can meet his or her fiduciary duties remains unclear: “[T]he disjunction between the appointment of directors and fiduciary duties is only sustainable because the purported objective of fiduciary duty – however formulated in theory – is not clearly defined at all.” 72

70 Id. (noting that some commentators are concerned that an increase in the “power of shareholders will likely (or perhaps necessarily) result in a greater focus on short-term profitability at the expense of the corporation's long-terms interests and the interests of other stakeholders.”).


ii. Activist Directors have Short Term Incentives – Due to the inherent nature of activist investing and the accompanying compensation schemes, sponsored directors are often incentivized to focus primarily on the short-term stock performance, which may not be in the best long-term interest of the corporation or other shareholders. Activists argue that directors’ interests are properly aligned if they are incentivized with stock, but this can cause directors to focus on too narrow a metric of success, and can lead to the type of agency issues that exist regarding CEO compensation and risk taking. When director compensation is solely focused on shareholder value and stock price, it “could lead directors to believe that their one and only concern should be to maximize share prices as quickly as possible…. [S]uch a short-term focus often does more harm than good.”

In the Hess and Agrium contests, both companies argued that the director compensation packages were designed to “incentivize these nominees to sell the company or promote some other extraordinary transaction in the short-run.” This argument is well grounded, considering that activist investors will frequently advocate for a dramatic merger, divestiture, or other shareholder distribution that can lead to an immediate jump in share value. A director is more jurisdictions, directors owe a uniform fiduciary duty to the corporation and its shareholders, creating a heterogeneity of duties with little clarification).

73 Molitor, supra note 68, at 150.

74 Coffee, supra note 14 (adding that “The great irony here is that the Dodd-Frank Act restricted incentive compensation to executives at major financial institutions precisely because such compensation was thought to have led to the short-termism and perverse incentives that produced the 2008 financial crisis. But no one thought about director compensation, which can do the same.”).
likely to favor such a short term dramatic transaction if he or she is likely to see direct financial gains from it.

Additionally, incentive compensation makes it more likely that a director would favor selling the company at a price today even if he or she would otherwise believe that the company could be worth more in three years.75 The immediate benefit of a current transaction can change the time horizon of a director’s risk evaluation. For example, shares of hypothetical ABC Corp are currently valued at $20 per share. An activist shareholder is advocating for an acquisition that would likely boost the stock to $25 per share in Year 1. But management believes that the acquisition could hamper the corporation long term, and that its new strategy could gradually raise the stock price to $33 per share by Year 3. In board deliberations, a salaried director who receives identical compensation in Year 1 as in Year 3 might have the patience to wait for a stock to slowly rise to $33. But an activist-sponsored director, who is guaranteed to reap millions of dollars from the immediate jump to $25, might be much more likely to favor the acquisition. The compensation package impacts the director’s evaluation of risk and return, increasing his or her preference for short-term transactions, even though they might forego long-term opportunity.76

iii. Changes Risk Management with the Company – In addition to changing how directors evaluate short term transaction risk, compensating directors based on immediate performance changes how risk is balanced within the company itself. Part of the purpose of paying directors guaranteed salaries is that it traditionally allows them to be more risk-averse than CEOs and

75 Id.

76 Id.
serve as a prudent counterweight to executive ambition. Like the activist-sponsored director in the ABC Corp hypothetical, ABC Corp’s CEO, whose compensation is tied almost exclusively to stock performance, is also likely to be more willing to take on long term risk for short term gain. But the salaried board of directors will rein in that strategy if they view it as too risky in the long run. However if the directors are also compensated based on short term gain, they may be just as willing to take on risk, depriving the corporation of a balanced risk evaluation process that is critical for long term stability.\textsuperscript{77}

\textit{iv. Divides the Board} – Another argument against activist compensation is that it may lead to hard feelings in the board room. Lucrative compensation for some directors can create two classes of directors on the same board, who do the same job but get paid very different amounts, which can often lead to resentment and disagreement between directors.\textsuperscript{78} Ultimately, such conflict within the board leads to losses borne by shareholders.\textsuperscript{79} Although disagreement is

\textsuperscript{77} Davidoff, supra note 2 (“Relatively modest compensation may ensure that directors act more prudently and serve as a counterweight to chief executives, who are more willing to shoot for the moon because their upside is so high. By paying directors as if they were chief executives, they may become all the more willing to take on more risk.”).

\textsuperscript{78} Id.

\textsuperscript{79} Glass Lewis, supra note 64 (“Glass Lewis recognizes that unequal compensation arrangements—like that proposed by the Hess shareholder—among directors can harm shareholders by impeding board cohesion and by creating conflicts of interests for directors who have received supplemental pay from a shareholder in consideration for their board service.”)
likely to exist in many board deliberations, personal pay conflicts exacerbate issues because they “Balkanize the board, creating suspicion and tension,” which limits the board’s ability to impartially evaluate a corporation’s strategy.80

III. Proxy Season Outcomes

Outcomes in recent proxy seasons hint that sponsor compensation is gaining mild approval from shareholders, who may not share the staunchly opposed position of corporations and their defenders. Identifying shareholder sentiment about compensation from this data can be difficult, because election of the activist-nominated directors is often more of a reflection of the shareholders’ opinions about the activist investor in general, not the directors’ compensation scheme. However, as the advisory firm Glass Lewis explains, “companies’ bylaws already require disclosure of any compensation arrangements maintained by director nominees. So if a nominee is party to a problematic deal, shareholders can render judgment on it by voting against the nominee in the director election.”81 Even though shareholders have the opportunity to vote against compensated directors, data on contested elections led by activist investors and on directors who failed to be reelected show a trend toward accepting the role of activist-nominated directors, and the sponsor compensation that often accompanies those positions.

a. Contested Elections

Institutional Shareholder Services (I.S.S.) has compiled data on proxy contests by activist investors, or dissident groups. Through the first half of 2013, activist dissidents sought to

80 Coffee, supra note 14.

81 Glass Lewis, supra note 64.
replace directors in 24 proxy contests, up from 19 in the similar time frame of 2012.\textsuperscript{82} While the frequency of these contests grows, the activists’ success rates are also climbing. In the first half of 2011, 56\% of proxy contests by activist dissidents were successful.\textsuperscript{83} Through the first half of 2012, the success rate dipped slightly to 43\%.\textsuperscript{84} However, the first half of 2013 saw a dramatic increase in success, with activists acquiring seats in 70\% of elections, with success rates of 64\% in smaller companies and 75\% in larger companies. Again, although it is difficult to draw firm conclusions, it appears that shareholders are becoming more accepting of activists nominating directors to board seats, and presumably aren’t vigorously opposed to the sponsor compensation that those directors often receive.

\textit{b. Incumbent Director Re-elections}

Despite significant publicity in early 2013,\textsuperscript{85} director re-elections during the 2013 proxy season did not reveal evidence that shareholders are opposed to director compensation for any incumbent directors. I.S.S. data reveals why certain directors were not elected, for reasons such

\footnotesize
\begin{itemize}
\item \textsuperscript{83} \textit{Id.} at 49.
\item \textsuperscript{84} \textit{Id.}
\item \textsuperscript{85} \textit{Id.} at 5 (“Despite dire pre-season predictions of stormy conditions by many pundits, the 2013 Proxy Season proved mild, as most boards basked in the glow of a strong stock market. The overwhelming majority of director candidates won reelection via landslide margins as advisory votes on pay continued to siphon off shareholders’ angst over compensation matters, and board outreach efforts dampened concerns over responsiveness.”).
\end{itemize}
as a director’s poor board meeting attendance, approval of exorbitant management pay, or commitment to too many boards. In 2013, 44 directors failed to win a majority of votes in re-election. Of those 44, none were ousted for reasons related to their compensation by shareholders or any other third party. The 2012 proxy season presented very similar results: 46 directors failed to win re-election, and none were ousted due to third party compensation.

As part of its shareholder advisory service, I.S.S. may recommend that a director not be re-elected. In 2013, the most frequently-cited reason that the I.S.S. gave a negative recommendation against a director was because of concern about the director’s independence. However, “[d]irectors in this category received average shareholder support of 90% of votes cast, and no directors who were in this category received less-than-majority support.” This overwhelming shareholder support “suggests that shareholders broadly do not view a violation of I.S.S.’s independence standards (which are, in some circumstances, more stringent than the company’s own independence policies under stock exchange rules) as a significant negative problem.” Additionally, analysis of the 2012 re-elections shows nearly identical results, with shareholders casting strong support for directors that I.S.S. had recommended against based on

86 Id. at 35.


89 Id.
independence concerns.\textsuperscript{90} This data is significant because the heart of the argument against sponsor compensation is that it compromises director independence, but shareholders seem largely unconcerned with I.S.S.’s independence recommendations, and are perhaps similarly unconcerned with how or who is paying their directors.

This pattern continued in 2014, when I.S.S. recommended against 768 directors on the basis of independence issues. In spite of I.S.S.’s negative recommendation, those directors received, on average, votes of support from 89\% of shareholders, confirming that even with the highly publicized issues regarding activism, shareholders do not seem significantly concerned with director independence.\textsuperscript{91}

As owners of the corporation, shareholders should be able to shape how its board of directors operates. If shareholders are not opposed to directors’ lack of independence or related compensation practices, then those practices should be accepted as a legitimate means of corporate governance.


As summarized by I.S.S., the 2013 proxy season was significantly characterized by activist shareholders’ pivot from focusing on structural governance issues to board member challenges. Yet referenda on director compensation by those activist shareholders stayed outside of the fray. Ultimately, regardless of compensation packages, shareholders will “vote for who they think is the better for the company and probably not pay much attention to the compensation issue… [with] performance and assessment of these companies… the most pressing point.” If shareholders are willing to vote for the directors whom they think will best serve the company, regardless of their sponsor compensation, perhaps corporations should be hesitant about adopting bylaws that would prohibit that compensation.

c. Provident Financial Holdings and Advisor Opinions

In November of 2013, Provident Financial Holdings, a small bank holding company, considered the issue of whether to re-elect three directors to a board that unilaterally passed a bylaw barring the nomination of sponsored directors. The Provident case is unique among other companies that have adopted similar provisions, because for perhaps the first time, the debate for the re-

92 Institutional Shareholder Services, supra note 79, at 5.

93 Davidoff, supra note 2; see also Coffee, supra note 63 (pointing out that when shareholders elect a sponsored director, the issue of the activist’s investment and the directors’ sponsor compensation have been bundled, and shareholders may have merely believed that their approval of an activist’s outside influence outweighed their disapproval of its director compensation plans).

94 Gelles, supra note 12.
The election of directors was centrally focused on their adoption of the prohibition, and it received significant outside attention.

I.S.S. came out against the re-election of the directors, arguing that the board did not take the bylaw change to a shareholder vote. I.S.S. further focused on the bylaw’s deterrent effect on nominating qualified directors, noting that the prohibition could drive away “board candidates selected for their strong, relevant industry expertise” who are affiliated with activist investors.

Martin Lipton offered a counterpoint, directly criticizing I.S.S. for announcing a “one-size-fits-all policy” that would discourage companies from trying to protect themselves against “inappropriate enrichment schemes” employed by activists and their directors. Lipton cited the panoply of policy arguments against the practice, arguing that I.S.S.’s recommendation would promote “fragmented and dysfunctional boards, conflicted and self-interested directors, and short-termist behavior.”

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96 Gelles, *supra* note 12.

97 *Id.*

98 *Id.*
The re-election was closely watched, and somewhat surprising in the eyes of some commentators. All three directors were re-elected, but with only an unusually low margin.\(^9^9\)

Upon revealing the election results, Provident defended its prohibitive bylaw, arguing that it prevented the potential for a board composed of “directors with distinctly different motivations.”\(^1^0^0\)

The Provident election reflects I.S.S.’s summary of the 2013 proxy season in general, with shareholders willing to overlook compensation issues in favor of re-electing the directors they believe are best for the corporation. However, it does show that when sponsor compensation is a central issue, shareholders may be willing to re-elect directors who ban it, but those directors will not receive the strong support that they may have received previously.

Ultimately, both I.S.S and Glass Lewis weighed in on the issue. In a recent FAQ section, I.S.S. adopted a new policy position that broadly considers the implementation of the bylaw without shareholder approval as a “material failure of governance”, which may lead to recommendation


(noting that the directors were re-elected with support of 65.9%, 66.6%, and 66.6%, which was significantly lower than the last time these directors were re-elected in 2010, when each received more than 89% of the vote).

\(^1^0^0\) Id.
of a vote against director nominees.\textsuperscript{101} This announcement was met with the expected consternation of Martin Lipton, who asserted that I.S.S. was “establishing a governance standard without offering evidence that it will improve corporate governance.”\textsuperscript{102} However, I.S.S.’s position was supported by Glass Lewis, which separately stated its policy that prohibitions of nominated director compensation should be put to shareholder vote and ultimately rejected.\textsuperscript{103} In spite of these pronouncements, many companies still consider prohibiting sponsor compensation, leaving the issue still up for vigorous debate.\textsuperscript{104}

IV. Case-by-Case Evaluations and the Middle Ground Responses

With activism a rising global strategy, and compensating board nominees becoming a regular practice, Martin Lipton and several other partners of Wachtell Lipton have proposed a model


\textsuperscript{103} Glass Lewis, supra note 64.

\textsuperscript{104} Id.
bylaw that any corporation can adopt to ban directors from being compensated by activists.\textsuperscript{105} Many corporations, such as Halliburton and Provident, have adopted that bylaw or others like it. The policy arguments made in favor of such a proposal are important: in some circumstances, performance compensation for directors could skew incentives against a corporation’s long-term best interests. However, a corporate board should not disregard the important policy arguments in favor of this practice and shareholders’ apparent tolerance of it. With these points in mind, boards should scrutinize individual compensation schemes as they arise, instead of adopting Wachtell’s bylaw and banning the practice outright.

\textit{a. The Wachtell Bylaw}

Lipton and his partners frame the potential harm posed by shareholder compensation: “In order to proactively address the threats posed by such schemes to the integrity of the boardroom and board decision-making processes, companies should consider adopting a bylaw that would disqualify candidates that are party to any such arrangements from serving as directors.”\textsuperscript{106} According to their proposal, corporations should adopt a universal ban on the practice that might look like this:

\begin{quote}
No person shall qualify for service as a director of the Corporation if he or she is a party to any compensatory, payment or other financial agreement, arrangement or understanding with any person or entity other than the Corporation, or has received any
\end{quote}


\textsuperscript{106} \textit{Id.}
such compensation or other payment from any person or entity other than the Corporation, in each case in connection with candidacy or service as a director of the Corporation. 107

This bylaw would prohibit directors from receiving sponsor compensation in any form: not for hiring, not for nomination, and not for election. The provision would allow for reimbursement only for out-of-pocket expenses related to election or for indemnification for expenses related to service. The bylaw sends a strong signal that the company will resist shareholder activism by adopting a firm measure to stop activists from employing an important strategy. As proponents might argue, this bylaw preserves the fiduciary integrity and independent decision-making of the board, which would be paid uniformly by the same entity, the corporation, with clear duties to the corporation and all of its shareholders equally.

However, the proposal is too new to determine what impact the bylaw might have on corporations, and it remains to be seen whether activists might actually be deterred from investing in a company that has adopted it.

b. The Case-by-Case Evaluation

Instead of adopting a bylaw that preemptively prohibits any type of sponsor compensation arrangement for activist-nominated directors, boards should evaluate actual compensation plans should they arise on a case-by-case basis. This is similar to the case-by-case evaluation

107 Id.
advocated for by I.S.S., which diverges from Glass Lewis’s blanket disapproval.\textsuperscript{108} By taking this case-by-case approach, the board retains the ability to guard against misalignment of interests for compensated directors, but still allows boards to benefit from agreeable shareholder activism, which can have a positive impact on the corporation’s bottom line.\textsuperscript{109} When a shareholder activist nominates directors, incumbent board members are in the best position to situationally evaluate the impact of having those nominees compensated by activist sponsors.

\textit{i. Evaluation Framework} - In evaluating nominee compensation plans, boards of directors should ask and collectively consider the following questions, in order of significance:

\begin{itemize}
  \item Question #1: Does the activist shareholder have a track record of aggressively focusing on short-term strategies, which might be supported by a director nominee?
  \item Question #2: Do the nominated directors have professional track records of corporate prudence?
  \item Question #3: Is the board, in its personnel composition, susceptible to “Balkanization,” or jealousy-based disagreement, if some of its directors are paid much more than others?
  \item Question #4: Are the nominated directors likely to retain their positions for a period that will outlast the activist’s investment period?
\end{itemize}


\textsuperscript{109} See Bebchuk, \textit{supra} note 44.
Question #5: Will the compensation method, whether paying for stock performance only, or for performance relative to peers only, have an impact on the director’s behavior in the current market?

ii. Evaluation Application – Question #1 is the most important, because it considers director compensation in the context of the greatest concern about activist investing. Incumbent directors must carefully examine a shareholder activists’ previous investments and consider whether the activist will push for a dramatic short-term shake-up, such as a major spin off, acquisition, or CEO firing. On the other hand, directors may consider the track record of the investor and see that it has a history of working in cooperation with management and incumbent boards to improve value. If the investor has a history of aggressive tactics, and the board reasonably believes that those aggressive tactics would not be in the best interest of the corporation, the board should loudly object to nominees’ compensation plans as part of a broader resistance effort. If the track record is more conservative, the board might consider allowing the sponsor compensation without protest.

Question #2 employs a similar evaluation of the directors’ track records. Many nominees are former business executives with extensive experience in corporate leadership. In previous management positions, have they made risky moves to drive up the value of their individual stock holdings? Or have they displayed greater prudence and conservative management?

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principles? If the director was previously willing to take short-term risks to maximize stock value as an executive, it may be highly likely that he or she would continue that behavior as a director if incentivized solely by stock value. But if the nominee has a long history of careful decision-making and conservative strategies, then he or she would likely still satisfy the board’s obligation to carefully evaluate risk within the company.

Question #3 is simply an evaluation of the personality of the board. Can incumbent directors avoid tension and bias when working with sponsored directors who will be paid much more? Although this may seem like a petty matter of personality conflict, it is critical to the board’s efficiency and effectiveness. If pay discrepancies might create issues on an already divided board, sponsor compensation plans should be resisted.

Question #4 considers the nominees’ long term commitment to the company. If the director is likely to remain on the board after the activist has reduced its stake, the director’s interests will be aligned with a longer term perspective, avoiding concerns about immediate shortcuts.

Question #5 can have an impact on director behavior depending on market and industry conditions. In a strong market that creates growth within the company’s industry, a director who is compensated based on stock price alone can receive gains simply by riding that market growth, without taking risky strategies. While that director may be able to focus on more conservative, long-term strategies, the automatic gains could also lead to passivity.

On the other hand, in the same strong market, a director who is compensated based on the company’s performance relative to peers might still be willing to take aggressive strategies, even though the market is driving the stock price up without resorting to such tactics. Even if the stock price goes up, that director won’t see any benefit unless the stock goes up more than peer
companies’, which may lead the director to take risky measures. Ultimately, it is up to the board to decide which compensation structure best reflects the risk approach that is most appropriate for the corporation in its current market.

c. The Middle Ground Responses

Considering these five evaluative questions together should help boards determine whether a nominee’s compensation plan is a threat to the long term welfare of the company, or whether it is unlikely to have an impact. If the board determines there is a threat that activist-sponsored nominees will pursue short-term gains to the exclusion of long-term opportunities, the company should respond to the potential activist advance in one of two ways.

The first measure, a tactic advocated by professor John Coffee, would be for the board to adopt a short term bylaw that prohibits sponsor compensation. The bylaw could be structured to apply only in short term situations that might apply to only a single director election, with a provision that requires any longer term adoption to be approved by shareholders. This approach would be a strong deterrent in a particular election that would effectively prohibit the activist from nominating and compensating directors. However, it would also avoid the long term downsides to such a prohibition, allowing for sponsor-compensated directors to be elected to the board once the short term prohibition expired, provided that the board approved of the qualifications and compensation of the nominee and the strategies advanced by the activist sponsor.

The second measure, employed successfully in recent corporate defenses, is to simply engage in a loud and public campaign against the activist’s compensation plans. Hess successfully used this strategy in its negotiations with Elliot Management. When Elliot sought to fill Hess’s board

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with directly-compensated directors, Hess objected to the aggressive scheme and took its “argument against Elliot’s director compensation arrangement to the airwaves and successfully raised enough questions to compel Elliot’s nominees to waive the arrangements.”\textsuperscript{112} If other companies would employ a similar strategy, it would allow them to forgo adopting a prohibitive bylaw, but still protect themselves from short-term aggression.

A third, and similar, measure, would be to require all sponsor compensation arrangements to be fully disclosed.\textsuperscript{113} Such full disclosure fits well with Hess’s strategy to wage a public campaign, and may serve as a deterrent as activists and director nominees may hesitate to commit to and publicize seemingly exorbitant pay incentives.

However, some boards may find that it is not necessary to adopt either of these defensive tactics. Unlike the ambitious strategies advocated by Jana, Elliot, and others, some activist investors do not intend to take aggressive action. For example, Clifton Robbins, founder of activist investor Blue Harbour Group, won’t invest in a company unless its management is receptive to his suggestions.\textsuperscript{114} In such cases, it makes less sense for a corporation to firmly resist the activist’s

\textsuperscript{112} Gold, \textit{supra} note 63.


board nominees’ compensation with either a short term bylaw or public campaign. If the activist investor doesn’t pursue an unruly risky strategy, it is unlikely that the activists’ directors will. In such cases, corporations should consider ceding seats to avoid the confrontational atmosphere that envelops proxy contests or public disputes about pay.\textsuperscript{115} There is an advantage to ceding board seats, even when there is potential controversy over pay, because it defuses tension between the company and the activist, before the issue becomes public and affects the company’s share price and market reputation.

Ultimately, the case-by-case approach benefits corporations because it is based around careful evaluation and communication with activists, rather than on permanent, preemptive fortifications. Unlike the corporate takeover era and the defensive strategies it created, the activist era requires improvement in the communication and interaction between the board and shareholders.\textsuperscript{116} In the previously cited survey, 50% of respondents, including both corporate executives and activists, believed that open dialogue and negotiation was the best method for corporations and activists arrive at mutually desired results.\textsuperscript{117}

Corporations and activists are coming to agreement more frequently as boards and activists realize that by opening dialogue and making equal concessions, corporations can avoid long and

\textsuperscript{115} Woolery, \textit{supra} note 49.


\textsuperscript{117} Schulte, Roth & Zabel, \textit{supra}, note 16, at 7.
costly battles. Even the prominent corporate-raider-turned-activist-investor, Carl Icahn, has remarked at being surprised at how easily he has won board nominations in 2013, noting that “[b]eing admitted to all these boards without a proxy fight would have been unthinkable only a year ago.”

This has been a part of a recent shift in the public perception of activist investors. Some media outlets and regulators, including Mary Jo White, chair of the Securities and Exchange Commission, have noted how activists have shed their corporate raider reputation by focusing on thoughtfully bringing strategic value to the boardroom.

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door when activists knock, corporate executives and directors have found that there is a 
significant benefit in engaging in a cooperative dialogue with activist shareholders. The case-
by-case evaluation framework can help boards facilitate that dialogue, creating a diverse working 
group that can partner with management to drive value.

V. Conclusion

Shareholder activism is an established practice in today’s market. Corporations and their boards 
must recognize that not only are activist investors always going to be at the gates, but they may 
in fact bring value to the company. While some corporations might choose to resist shareholder 
activism entirely through long, public battles or broad prohibitive bylaws, others have found 
value by negotiating and working with activists.

+28HBR.org%29, (“Contrary to the adverse experience of some governing boards, activist 
investors can actually prove to be a leadership asset on the board rather than a disruptive force – 
providing the boardroom is well-managed and led.”).

120 Id.

121 Michael Useem and Dennis Carey, What Smart Boards Do When Investors Knock, HARBARD 
BUSINESS REVIEW BLOG NETWORK, Dec. 16, 2013, available at 
ss+%28HBR.org%29 (discussing how it is in the best interests of corporations to engage in 
collaboration with activist shareholders to create “mutually assured construction rather [than] 
destruction.”).
The policy arguments against sponsor compensation go to the heart of corporate law: the fiduciary loyalty of the director cannot be compromised. But activist compensation may be a more effective means of aligning the interests of the directors with the corporations they serve, and corporations should avoid adopting broad policies that prevent major shareholders from nominating qualified candidates to the board.

Instead, corporations should consider the compensation offered to these candidates on a case-by-case basis, giving activist strategies proper scrutiny without overreacting to potential threats with broad prohibitions. This approach ultimately preserves greater flexibility in the corporation’s internal governance and response to activists, and allows the corporation to determine the best way to maximize its overall value.