ACTIVIST NOMINEE COMPENSATION: BALANCING THE HEDGEHOG'S DILEMMA

NITHYA NARAYANAN*

ABSTRACT

Compensation of board directors, who are nominees of activist shareholders, by such activist shareholders, has thrown up a plethora of issues. Many have advocated for an absolute proscription of such remuneration made by third parties, other than the corporation. Currently, there exists nothing in the law, which makes this practice unlawful or precludes shareholders from nominating their candidates on the board of the corporation and entering into compensation arrangements with them. This article addresses each of the concerns raised by the opponents of activist nominee compensation and posits that none of the concerns are grounds sufficient enough to permit corporations to adopt bylaws disqualifying directorial candidates solely on the basis of their source of compensation. By disproving the apprehensions expressed in relation to this practice, this article suggests that shareholders of a corporation are best suited to decide the candidates they want to elect on the board of the corporation. Thus, instead of interfering with their electoral rights, corporations should consider full and detailed disclosure of the compensation arrangements between the activist shareholders and their director nominees before such election. This article also sheds light on the role and importance of hedge fund activist shareholders in the corporation, rebuffing the unproved claims of their short-termist behavior and their disparate impact on consensual board decision-making. Rather than outright preclusion of activist nominee compensation, the article concludes by putting forth different compensation strategies, which could be adopted by activist shareholders while incentivizing their board nominees, thereby mitigating the anxieties caused by such practice.

> *When a fight breaks out in a bar, you don't hit the man who started it. You clobber the person you don't like instead.*[1]

---

*This article represents the position of law as of March 15, 2015. I would like to thank Professor Reinier Kraakman for supervising this paper, and for his invaluable suggestions and encouragement throughout. I am grateful to my colleagues in the Harvard Law School Corporate Governance Concentration for sharing their thoughts with me on this subject. I also want to thank Mr. Kobi Kastiel for his critical inputs. Any faults, which may be found with this paper, however, may be attributed to me alone. I can be contacted at nnarayanan@llm15.law.harvard.edu.

[1] *Payback Time*, THE ECONOMIST (Nov. 21, 2009).

TABLE OF CONTENTS

I. INTRODUCTION 347
II. BACKGROUND 350
III. THE WACHTELL DISQUALIFYING BYLAW
IS NOT LEGALLY TENABLE 353
A. *The Wachtell Disqualifying Bylaw*
Violates Shareholder Franchise 353
B. *The Wachtell Disqualifying Bylaw*
Would Not Survive Blasius Scrutiny 355
IV. LEGISLATIVE VACUUM IN ADDRESSING
BOARD INDEPENDENCE 357
A. *Interplay between Exchange Rules and Delaware:*
Existence of a Vacuum? 358
B. *Why Special Compensation Enhances*
Independence In Nominee Directors 361
V. DEBUNKING CLAIMS OF CORPORATE SHORT-TERMISM 362
VI. IN DEFENSE OF ACTIVIST HEDGE FUNDS 365
A. *The Gap-Filling Role of Hedge Funds* *366*
B. *Unity of Interest of Shareholders* 368
VII. SPECIAL COMPENSATION:
A THREAT TO BOARD COHESIVENESS? 370
VIII. REFORMULATING THE ALLEGEDLY
MACHIAVELLIAN DISSENT DIRECTOR
COMPENSATIONS AND RECOMMENDATIONS 374
A. *Stock Ownership and Duration* 381
B. *Company Performance-based compensation* 383
C. *Bonus Payments* 385
D. *Changing Company Bylaws and Policies* 386
E. *Reinforcing Disclosure Requirements* 388
IX. CONCLUSION 389

I. INTRODUCTION

During the winter, hedgehogs[2] group together to stay alive and protect one another from the cold; however, this also causes them to hurt their companions with their quills. They face a choice between accepting the wounds of such quills (but surviving), and distancing themselves from their group (and dying). This is the hedgehog's dilemma.[3] I use this metaphor to explain the relationship between activist hedge funds and a company's management. Neither can do without the other. Activist shareholders, like hedge funds, play an active role in governing companies in which they hold stake, shifting the board-centric corporate landscape to one where shareholders exercise significant influence in corporate decision-making, through proxy contests and other interventions. Despite knowing the fact that hedge funds contribute to increasing firm performance, the company's management despises shareholder intervention. They face the hedgehog's dilemma, for each of them plays an important part in pursuing economic benefits for the corporation. Compensation packages adopted by activist shareholders, which are used to pay their board nominees, have exacerbated this already existing hedgehog's dilemma. With board compensation as the central theme, the primary goal of this Article is to formulate and put forth proposals of alternative remuneration arrangements for nominee directors of hedge funds, which could not only ensure optimal long-term performance of the company, but also balance the hedgehog's dilemma confronted by these activist shareholders and executives, alike.

Before diving into the normative, legal, and social aspects of hedge funds compensating their nominees, Section II of the article gives a brief background on the genesis of this issue, by discussing the activist crusade of Jana Partners LLC ("Jana") and Elliott Management Corp. ("Elliott"), who announced an incentive pay structure for their own director nominees on the boards of Agrium Inc. ("Agrium") and Hess Corporation ("Hess"), respectively. The companies and their management vociferously challenged such arrangements as 'golden leashes'; alleged such nominees were hen-pecked servants of their activist masters, and therefore incompetent to serve as board members.[4]

---

[2]*Hedgehog*, COLLINS ENGLISH DICTIONARY (12th ed. 2016), *available at* http://tinyurl.com/hxevnuk (any small nocturnal Old World mammal of the genus *Erinaceus*, such as *E. europaeus*, and related genera, having a protective covering of spines on the back: family *Erinaceidae*, order *Insectivora* (insectivores)).

[3]Arthur Schopenhauer, PARERGA AND PARALIPOMENA (Volume II, Chapter XXXI, Section 396 1951).

[4]Peter Goven, Jana's Agrium Proxy Battle had Little Chance of Succeeding, Financial Post (Apr. 12, 2013), available at http://tinyurl.com/GM-12iv13; Stephen Erlichman, Agrium

Some members of the legal industry also backed this view. A memorandum ("Wachtell Memo") released by the law firm, Wachtell, Lipton, Rosen & Katz ("Wachtell"), suggested adoption of bylaws disqualifying shareholder nominees from being elected on the company's board while receiving compensation from third parties ("Wachtell Disqualifying Bylaw").[5] While some proxy advisors cast doubts on Wachtell's accusations that hedge funds compromise the firm's long-term performance, there is no uniform view.[6] Professionals have considered whether private compensation arrangements between the activist shareholders and their nominee directors could undermine the bedrock of corporate law. The subsequent sections of this article refute each of the contentions made against compensating nominee directors by activist third parties.

The Wachtell Disqualifying Bylaw advocated that companies unilaterally adopt a bylaw disqualifying an individual from board membership, if that individual had a compensation arrangement with a shareholder. Section III questions the validity of the Wachtell Disqualifying Bylaw, and argues that the adoption of such a bylaw is directly in conflict with, and in violation of, the fundamental right of the shareholder electorate, and therefore is without any rational justification. Adopting such a bylaw precludes shareholders from the opportunity of deciding the composition of the decision-making body of the corporation, thereby undermining the shareholders' voices. This section also argues that the Wachtell Disqualifying Bylaw would not survive the *Blasius* standard of scrutiny.[7]

Special compensation arrangements for hedge fund board nominees have been criticized for many reasons. Such compensation arrangements, being provided by non-company third parties, are alleged to compromise the independence of the nominee directors. It is assumed that they would be inclined to represent and further the interests of only

---

payments don't pass the "smell test," The Globe and Mail (July 4, 2013), available at http://tinyurl.com/zosekyu.

[5]Martin Lipton, Bylaw Protection Against Dissident Director Conflict/Enrichment Schemes, Harvard Law School Forum on Corporate Governance and Financial Regulation (May 10, 2013), http://tinyurl.com/HLS-13v10.

[6]*See* Allen C. Goolsby & Steven M. Haas, Compensatory Arrangements Between Hedge Funds and Their Director Nominees, Hunton & Williams, Hunton & Williams Client Alert (July 2013), http://tinyurl.com/zgqxsc3; Director Qualification/Compensation Bylaw FAQs, Institutional Shareholder Services (Jan. 13, 2014), http://tinyurl.com/ny5rsfn. (ISS warns that if a board adopts "restrictive director qualification bylaws" designed to prohibit "golden leashes" without submitting them to a shareholder vote, ISS "may" recommend a withhold vote against director nominees "for material failures of governance, stewardship, risk oversight, or fiduciary responsibilities").

[7]*See* Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

their appointee shareholders.[8] Section IV of this article examines the concept of "independence" as understood under the DGCL, Sarbanes-Oxley Act of 2002, and rules of self-regulatory organizations, such as the NASDAQ and the New York Stock Exchange ("NYSE"). Section IV additionally addresses judicial precedents, in order to assess if board nominees of activist hedge funds could be disqualified for being non-independent. It is found that such nominee compensation arrangements have yet to be declared illegal by a court or found to be in violation of any rule of law. Traditionally, directors are required to be independent *vis-à-vis* management and not *vis-à-vis* shareholders. This section delves into the purpose of performance-based compensations, and sheds light on the fact that these arrangements enhance board independence by contributing and optimistically signaling director confidence to the capital markets.

Section V of the article addresses the allegations that hedge fund nominees having a short-term focus, aiming at short-term performance of the company, in turn compromising the company's long-term objectives. The section contends that it is not justifiable to ban bonuses and special compensation for the nominee directors solely on the basis that the hedge funds nominating them tend to be short-term shareholders of a company. This argument finds support in empirical studies, which disprove unfounded allegations of the adverse impact of hedge fund activism on long-term performance of a company.[9]

Section VI defends hedge funds, and contrasts the role of hedge funds from institutional investors. It underscores the gap-filling role assumed by hedge funds as monitors of managerial discretion. Furthermore, this section challenges the presumption that the interests and goals of shareholders are always diverging, and that being construed as the reason for the mistrust surrounding hedge funds.

There is a strong concern that special incentives for nominee directors threaten to balkanize the board into hostile competing groups.[10] Section VII of the article, focuses on the structure and manner of board compensation adopted by companies, noting that even in the absence of a hedge fund nominee, the board compensation is not uniform for all the members. The section argues that the recompense offered by hedge

---

[8] *See* John Coffee, *Shareholder Activism and Ethics: Are Shareholder Bonuses Incentives or Bribes?* THE CLS BLUE SKY BLOG COLUMBIA LAW SCHOOL'S BLOG ON CORPORATIONS AND THE CAPITAL MARKETS (Apr. 29, 2013), http://tinyurl.com/CLS-13iv29; Steven Solomon, *Upping the Ante in a Play for a Stronger Board*, NEW YORK TIMES (Apr. 2, 2013), *available at* http://tinyurl.com/NYT-DB-13iv02.

[9] *See* Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 Colum. L. Rev. 1637, 1640–41 (2013).

[10] Lipton, *supra* note 5, at 1.

funds to their nominees, by way of firm performance-based bonuses and retainer fees, does not result in a dysfunctional board. Prohibiting special compensation for activist nominees would deter, rather than motivate the nominees in pursuing their value-creating function in the company.

A hedge fund nominee's ability to act objectively and independently from management is directly proportional to the nominee's remuneration and the company's performance. Therefore, Section VIII of this article proposes various remunerative mechanisms that hedge funds could adopt to pay their nominee directors. These mechanisms include, lengthening the duration of the director's performance review, altering the timing of their disbursement and suggesting a payoff schedule, which is a combination of cash compensation and alternative instruments like stock options, and restricting stock and the like. These mechanisms would aid in achieving an ideal remuneration structure for activist nominees and bringing about effective corporate governance. This section highlights certain mitigating strategies that the company could adopt *ex-ante* the nomination of the board members by shareholders, especially in light of the *Kalisman, et al.* v. *Friedman, et al.*[11] decision ("*Kalisman* Decision") of the Delaware Chancery Court. Section IX concludes.

II. BACKGROUND

Though shareholders have always been equipped to initiate a proxy battle against the company's incumbent board under the SEC regulations, owing to the exorbitant costs associated with it, this channel of seeking representation and being heard has been slowly gaining popularity. The year 2013 saw numerous proxy fights against the management of S&P 500 companies, which was significantly higher than previous years.[12] However, the remuneration strategy adopted by some activist hedge funds in compensating their nominees became the

---

[11]2013 WL 1668205 (Del. Ch. Apr. 17, 2013). The Kalisman decision suggests that in the absence of an appropriately imposed limitation, an activist-sponsored director might be free to serve as a confidential information conduit to the activist sponsor. *Id.* at *6. Thus, in order to mitigate issues that could arise from a director's unfettered access to information and the subsequent flow to the shareholders, contractual limitations could be imposed on the board members of a company. *Id.* at *4. This is discussed in Section VIII of the article. *See infra*, Section VIII.

[12]Mateo Tonello, *Proxy Voting Analytics (2009-2013)*, Harvard Law Schools Forum on Corporate Governance and Financial Regulation (Sept. 26, 2013), http://tinyurl.com/HLS-26ix13.

cynosure of widespread debate and discussion in the academic and business circles.[13]

Compensation of nominee directors of hedge funds received a fair amount of scrutiny after activist hedge funds Jana and Elliott announced an incentive pay structure for their own director nominees on the boards of Agrium and Hess.[14] Board passivity has been a constant grievance of activist shareholders who believe that inadequate compensation paid to board members is one of the main reasons for underperformance seen in companies.[15] With the objective of improving Agrium's performance compared to its peers, Jana acquired around 7.5% of Agrium, an agricultural supply retailer and wholesaler based in Canada, and nominated five directors to its twelve-member board.[16] There was nothing unusual about the actions of Jana, for activists are generally on the lookout for companies deteriorating in performance and facing corporate governance issues.[17] Jana announced that it was going to pay each of its nominees an upfront nomination fee (fees for agreeing to contest as its nominee on Agrium's board) of $50,000.[18] If elected on board, in addition to the company-determined compensation for directors, the hedge fund nominees were promised 2.6 percent of Jana's net profit, based on the performance of Agrium's share price.[19] Even if not elected, they were entitled to receive 1.8 percent of Jana's net profit.[20] Though Agrium called such compensation 'golden leashes', the dispute regarding the legality of such compensation structure remained unresolved as Jana lost the proxy fight.[21]

Similarly, when Elliott acquired about $800 million worth of stock in Hess, it nominated five directors to the fourteen-member Hess board.[22] Elliott agreed to pay a retainer fee of $50,000 for each of its five board nominees on Hess, and indemnify them for legal liability.[23] Additionally, it agreed for all such nominees to receive a lump sum

---

[13]Lipton, supra note 5, at 1.

[14]*See infra*, Section VIII.

[15]Kay Ng, *Inside the Boardroom: A Proposal to Delaware's Good Faith Jurisprudence to Improve Board Passivity*, Yale Law School Legal Scholarship Repository at 8 (Oct. 2017), available at http://tinyurl.com/SSRN1056.

[16]Solomon, *supra* note 8.

[17]*But see* Peter Goven, *Jana's Agrium Proxy Battle had Little Chance of Succeeding*, FINANCIAL POST, (Apr. 12, 2013), *available at* http://tinyurl.com/fp-ag02iv13.

[18]Steven Solomon, *Upping the Ante in a Play for a Stronger Board*, NEW YORK TIMES (Apr. 2, 2013), *available at* http://tinyurl.com/NYT-DB-pfsb.

[19]*Id.*

[20]*Id.*

[21]*Id.*

[22]*Id.*

[23]Lawrence Cunningham, *Director Bonuses for Performance, Prawf Debate and the Bigger Picture for Hess*, CONCURRING OPINIONS (May 1, 2013), http://tinyurl.com/CO-13v1.

bonus amount at the end of three years, for each percentage point that the stock price of Hess outperforms the stock of its peers.[24] This arrangement was considered objectionable by the Hess management, which was of the view that it would induce its recipients to serve as short-term shareholders rather than as "long-term stewards."[25] The three-year gestation until remuneration contributed to allegations of possible allegiance of such nominee directors to the nominating hedge funds, thereby compromising the board's independence.[26] However, Elliott and Hess reached a settlement before the shareholder voting, under which the nominees agreed to waive their right to such payments, and Hess agreed to give Elliott three board seats and separate the roles of the company's chairman and CEO.[27]

Despite the opposition to such arrangements by the companies and their management,[28] proxy advisory firms like Institutional Shareholder Services Inc. ("ISS") and Glass Lewis & Co. ("Glass Lewis"), recommended in favor of one or more of the dissident nominees, and indirectly endorsed such compensation arrangements.[29] ISS's tacit support however, is not absolute and requires shareholder approval before ISS applies a "case-by-case analytical framework" in order to determine whether it will recommend the proposed bylaw.[30]

However, the legal industry has reacted adversely to these arrangements, with the highlight being the Wachtell Memo that suggests a board-adopted bylaw to counter the practice of such third-party compensations.[31] It disqualifies any person from being a director of the company, should such person be 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 such compensation or other payment from any person or entity other than the Corporation.*[32] In effect, the Wachtell Disqualifying Bylaw permits the

---

[24]*Id.*

[25]*Id.*

[26]*Id.* (stating that incumbents believe the benefits compromise the nominee director's independence; however, the author takes the opposite approach).

[27]Michael J. de la Merced, *How Elliot and Hess Settled a Bitter Proxy Battle*, N.Y. TIMES (May 16, 2013), http://tinyurl.com/NYT0DB-13v16.

[28]*See* Janet Mcfarland, *Jana's Agrium pay scheme draws fire*, THE GLOBE AND MAIL (Mar. 04, 2013), http://tinyurl.com/GM-1066.

[29]Director Qualification/Compensation Bylaw FAQs, *supra* note 6.

[30]*See id.*

[31]*See* Lipton, *supra* note 5.

[32]*Id.* The full text of such provision reads as follows:

> 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 such compensation or other payment from

company's management and its board to subrogate themselves in place of shareholders, and unilaterally decide upon the candidates, who qualify for election. The following Section III of this article questions the legality of this Wachtell Disqualifying Bylaw. It argues that the manner of adoption of such bylaw is directly in conflict with, and in violation of, the fundamental right of the shareholder electorate and is without any rational justification.

III. THE WACHTELL DISQUALIFYING BYLAW IS NOT LEGALLY TENABLE

This section specifically refers to the Wachtell Memo, which advocates that companies should adopt the recommended Wachtell Disqualifying Bylaw that disqualifies shareholder nominees from being elected on board of the companies, if they are compensated for their service by an entity or a person other than the company. I posit that the Wachtell Disqualifying Bylaw is not legally defendable under the standard laid down by the Delaware Court of Chancery in *Blasius Industries, Inc.* v. *Atlas Corp.* (*Blasius* Standard).[33] For reasons specified below in this section, the procedure for electing members for board directorship should solely rest in the decision-making prowess of the shareholders, without the incumbent directors or the management of the company prompting with additional qualifications for board members.

A. *The Wachtell Disqualifying Bylaw Violates Shareholder Franchise*

While the history of corporate governance suggests that the model of shareholder primacy is supreme and that shareholder value maximization is the main purpose of the corporation,[34] this is not reflected in the rights awarded to shareholders. Though shareholders are the owners and ultimate beneficiaries of the corporation, in the true

any person or entity other than the Corporation, in each case in connection with candidacy or service as a director of the Corporation; provided that agreements providing only for indemnification and/or reimbursement of out-of-pocket expenses in connection with candidacy as a director (but not, for the avoidance of doubt, in connection with service as a director) and any pre-existing employment agreement a candidate has with his or her employer (not entered into in contemplation of the employer's investment in the Corporation or such employee's candidacy as a director), shall not be disqualifying under this bylaw.

[33] 564 A.2d 651 (Del. Ch. 1988).

[34] *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440-43 (2001).

sense, they do not manage and control the functioning of the corporation.[35] Management of the business and affairs of the corporation is vested under the direction of a board of directors.[36] While the state law makes the role of the board of directors abundantly clear, the responsibilities of shareholders are rather blurred. Having said that, one of the most important and primary rights conferred on shareholders is the right to vote on certain vital matters relating to the business, including the right to elect the members of the board of the company, which gives them indirect control over the affairs of the company.[37] Thus, the right to elect the directors of the corporation is considered to be a fundamental right of the shareholders.[38]

The Wachtell Disqualifying Bylaw disqualifies a person from being eligible for election to the board of directors if he is nominated by a shareholder who is also compensating him, independently of the corporation.[39] The Wachtell Memo suggests that the board of directors of the corporation could adopt the Wachtell Disqualifying Bylaw without providing for any shareholder consultation.[40] This essentially means that the board can singularly decide on a matter, which directly affects the fundamental right of the shareholders concerning director election. Thus, the Wachtell Memo restrained shareholder choice by advocating that a company's board should unilaterally decide on the matter.[41] However, by May 20, 2014, twenty-eight of the thirty-two companies known to have unilaterally (*i.e.* without shareholder approval) adopted the Wachtell Disqualifying Bylaw had retracted it in whole or in part.[42]

Before, and in the absence of the Wachtell Disqualifying Bylaw, shareholders evaluated candidates based on their merits, interests, qualifications, prior relationships with the company, if any, and experience, all of which was fully disclosed in the proxy statement, prior to the annual general meeting.[43] The federal securities laws require disclosure of the details of the nominated candidate and his terms of any

---

[35] *See Del. C.* § 141(a) (2006); *see also* MODEL BUS. CORP. ACT § 8.01(b) (2004).

[36] *Id.*

[37] *See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 413–24 (2006).

[38] *Id.*

[39] *See* Lipton, *supra* note 5.

[40] *Id.*

[41] Carl Icahn, *Disqualifying Dissident Nominees: A New Trend in Incumbent Director Entrenchment*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Feb. 12, 2014), http://tinyurl.com/z2135ca.

[42] Matthew D. Cain, Jill E. Fisch, Sean J. Griffith and Steven Davidoff Solomon, *How Corporate Governance Is Made: The Case Of The Golden Leash*, PENN LAW: LEGAL SCHOLARSHIP REPOSITORY 649, 653 (2016) (on file with the Penn Law: Legal Scholarship Repository), http://tinyurl.com/zz5ugjt.

[43] *See* Ichan, *supra* note 41.

compensation with the nominating shareholder, based on which the shareholders could determine whether or not to elect the activist's candidate.[44] If the company wants to adopt a bylaw of the nature suggested in the Wachtell Memo, it should put it to a shareholder vote. If the shareholders support a company bylaw limiting their choice of candidates to be elected on board of the company, they would approve it. The incumbent board should not be allowed to veto and undermine shareholder voice.

B. *The Wachtell Disqualifying Bylaw Would Not Survive* Blasius *Scrutiny*

In addition to being in violation of shareholder franchise, the Wachtell Disqualifying Bylaw would also fail the *Blasius* Standard enumerated by the Delaware Court of Chancery.

Blasius, a 9% shareholder of Atlas, sought to expand the board of directors of the company from seven to fifteen members, by naming eight new directors.[45] In response, the incumbent board of directors expanded the size of the board to nine members, by appointing two new directors, in order to prevent Blasius from naming a majority of directors.[46] The court in this case held that whenever directors act for the primary purpose of thwarting shareholder vote, their actions could not be upheld without a compelling justification.[47] Since then the courts have recognized the need to prevent directors from intentionally interfering with shareholder democracy.[48] The *Blasius* Standard requires the board of directors to provide a "compelling justification" for actions that interfere with or impede the effective exercise of the shareholder franchise.[49]

The shareholders, as owners of the company, have the right to elect the best-qualified and best-suited persons to the company's board

---

[44] *Id.*

[45] *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 652 (Del. Ch. 1988) ("As amended, it challenges the validity of board action taken at a telephone meeting of December 31, 1987 that added two new members to Atlas' seven member board. That action was taken as an immediate response to the delivery to Atlas by Blasius the previous day of a form of stockholder consent that, if joined in by holders of a majority of Atlas' stock, would have increased the board of Atlas from seven to fifteen members and would have elected eight new members nominated by Blasius.")

[46] *See id.* at 655. ("There is testimony in the record to support the proposition that, in acting on December 31, the board was principally motivated simply to implement a plan to expand the Atlas board that preexisted the September, 1987 emergence of Blasius as an active shareholder.")

[47] Velasco, *supra* note 37, at 431.

[48] *Id.* at 431-32.

[49] *See supra* note 44-48 and accompanying text.

based on their assessment of the candidates contesting for this position.[50] So far there is no law prohibiting them, neither the board nor the company has any locus to impede the nomination by such shareholders. The author agrees with the viewpoint advanced by the attorney at Schulte Roth & Zabel LLP—shareholder franchise includes not only the right to vote and elect a new slate of nominee directors, but also the right to determine the manner and terms of such nomination.[51] Preventing a candidate from receiving compensation from the nominating shareholder cannot be a justified disqualification; it is nothing but an example of the board's entrenchment efforts, which limits the activist shareholder's influence in challenging the management's slate of directors and participation in changing the *status quo* of an underperforming company. In this author's view, it appears that the immediate and only effect of enacting this bylaw is to make the board of directors in a company the final decision-making body *vis-à-vis* director compensation, thereby impeding the shareholders' recruiting mechanism. Should this issue get litigated in the courts, the board would be required to give cogent reasons for disenfranchising the shareholders in order to fulfill the "compelling justification" test.[52] The Wachtell Memo lists out "threats" that are posed when shareholders are permitted to compensate board members, but the same are untested and unconvincing to create an impact.[53] The courts should easily be able to look through the *malafide* intention behind the adoption of such bylaw. Moreover, in several cases Delaware courts have re-affirmed that appropriate equitable relief would be provided in instances where the shareholders' franchise rights are thwarted for improper purposes.[54]

A lot of emphasis has been laid on the potential conflict of interest that could arise between the shareholder nominee directors and the existing board members. Surprisingly very little is being said about the conflict of interest of the incumbent board with their prospective competitor directorial candidates when they adopt a bylaw of the nature suggested in the Wachtell Memo. The next section of this article will discuss the merits of the conflict of interest allegations pinned to such

---

[50]*See* Ichan, *supra* note 41.

[51]Brandon S. Gold, *Why the Wachtell Bylaw on Director Compensation by Shareholders is Overbroad and May Fail Blasius Scrutiny*, THE CLS BLUE SKY BLOG COLUMBIA LAW SCHOOL'S BLOG ON CORPORATIONS AND THE CAPITAL MARKETS (May 31, 2013), http://tinyurl.com/hx8ukxs.

[52]*Id.*

[53]Lipton, *supra* note 5.

[54]*See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971); Portnoy v. Cryo-Cell Int'l, Inc. 940 A.2d 43, 69, 72 (Del. Ch. 2008).

activist shareholder nominees, who are claimed to lack independent decision-making capability.

IV. LEGISLATIVE VACUUM IN ADDRESSING BOARD INDEPENDENCE

In his seminal piece, Jeffrey Gordon traced the evolution of independent directors in U.S. public companies over five decades.[55] He conceded that there was no clear evidence that indicates a company's stock performance was directly proportional to an increase in the percentage of independent directors on board of the company.[56] However, his article does not delve into the aspects of what factors make a director truly independent. The evolving and expanding contexts of independence in these present times reveal the limitations in the regulatory qualifications for an independent director.[57] Opponents of special compensation for hedge fund nominees asserted absence of director's independence is a major concern.[58] There is an underlying apprehension that different shareholder groups have conflicting goals, and the nominees of the hedge funds might favor the short-term ends of these hedge funds, compromising on the long-term welfare of the company.[59] The bonus payments coupled with performance-linked incentives promised by the nominating shareholder, in addition to his salary paid by the company creates a presumption that the nominated director would compromise on his impartiality.[60]

This section analyses the regulatory requisites that define the independence of board directors and contrasts them with the judicial explanation provided by Delaware courts. Neither interpretation *ipso facto* disqualifies a shareholder's director nominee or shareholder group from being independent. If having shareholder representative directors on a company's board raises independence-related concerns, then the law in its existing form doesn't address the same. To the contrary, the incentive based special compensation for such nominees enhances questioning their independence; it indicates the nominee candidate's trust in the company and its potential for better performance.

---

[55] Jeffery 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, 1469 (2007) (discussing the evolution of the board of directors of a corporation over the past fifty years).

[56] *Id.* at 1500.

[57] *See infra* Part IV.A.

[58] *See infra* note 76-77 and accompanying text.

[59] *See infra* Part V.

[60] *See infra* note 79-82 and accompanying text.

A. *Interplay Between Exchange Rules and Delaware: Existence of a Vacuum?*

Board independence requirements were solely within the ambit of the state corporate laws, until the Sarbanes-Oxley Act of 2002 required the national stock exchanges, NYSE and NASDAQ, to determine the independence of the members of a listed company's board and audit committee.[61] They require a majority of the board and the entire audit committee to be independent.[62] However, there exists a divergence in the criteria of independence promulgated by the NYSE and NASDAQ rules on one hand, and the Delaware corporate law and judiciary on the other. An *ex ante* rule based approach is adopted by NYSE and NASDAQ; they prescribe objective corporate governance thresholds, identifying the relationships, which disqualify independence of a director.[63] They seek to exclude all familial, pecuniary relationships with the company, management and directors from the trappings of independence, assuming that with such disinterested outsider status, independence in the boardroom is achievable.[64] Whereas in Delaware, determining independence, or lack thereof, of a board member is "contextual."[65] The courts go beyond the bright-line test of independence laid down by the national securities exchanges; the discovery process involves an analysis of a complex set of facts surrounding the alleged breach.[66] Just like Delaware courts apply different standards of review for claims of fiduciary duty breaches by directors, they adopt diverse approaches while examining independence

---

[61] *See* Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 NOTRE DAME L. REV. 1159, 1169-70, 1172 (2005) (explaining that prior to the Sarbanes-Oxley Act, corporate governance was generally left to the state, but the Sarbanes-Oxley Act now requires the National Stock Exchanges to determine board independence requirements).

[62] *See* NYSE, Inc., Listed Company Manual § 303A.01 (2003) (stating that a majority of the board must be independent); NASDAQ, Inc., Listing Rule 5605-1 (2009) (stating that a majority of the board must be independent); NYSE, Inc., Listed Company Manual § 303A.07(a) (2003) (stating that the audit committee must meet the independence requirements listed in § 303A.02); NASDAQ, Inc., Listing Rule 5605-4 (2009) (stating that the audit committee must be independent).

[63] *See* Seligman, *supra* note 62, at 1172-74 (explaining the board independence requirements under the National Stock Exchanges' rules).

[64] *See id.* (explaining the board independence requirements under the National Stock Exchanges' rules).

[65] *See In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 941 (Del. Ch. 2003) (explaining that Delaware courts use a contextual approach in determining board independence).

[66] *See id.* at 941-42, 941 n.62 (explaining that, in Delaware, courts should consider all relevant factors and circumstances in determining board independence).

of such directors.[67] Having said that, neither the exchange requirements nor the Delaware precedents suggest that under the existing law independence of directors is required to be maintained *vis-à-vis* shareholders of the company. The concept of independent board members arose from the need for someone to monitor managerial actions and ensure shareholder value enhancement.[68] Independence of the board is thus necessary concerning the management.

Thus, it is difficult to comprehend how nominees of shareholders on the board could undermine the board's independence. Usually, it is the management that nominates its slate of potential board members for election by the shareholders.[69] In cases where a shareholder or a shareholder group intends to have their representatives on the board, they initiate a proxy fight and put forth their slate of potential board members.[70] As the final election of the board members is the prerogative of the shareholders, there is no justification to negate their competency to decide upon the remuneration of a board nominee candidate or selecting him to be a part of it. Moreover, once appointed, these nominee directors and their actions are subjected to the same level of scrutiny as the other members of the board.[71] Hence, if the fear is the possibility of bias towards the nominating shareholder group, the same doesn't have a rational basis. Irrespective of whether the nominating and compensating entity forms a part of the management or a shareholder group, once their remuneration has been disclosed before their election and they have been elected by the shareholder body, under the law, there would be no differential treatment given to the execution of their responsibilities as a part of the board of the company. They would be required to comply with a director's obligation to act in good faith and in the corporation's

[67] *See id.* at 938-39 (explaining that Delaware courts have applied general standards of review inconsistently).

[68] *See* Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U. L. REV. 381, 385 (2005) (explaining that the need for more independent directors was a result of corporate governance failures).

[69] *See* Rose A. Zukin, *We Talk, You Listen: Should Shareholders' Voices Be Heard or Stifled When Nominating Directors? How the Proposed Shareholder Director Nomination Rule Will Contribute to Restoring Proper Corporate Governance*, 33 PEPP. L. REV. 937, 940 (2006) (explaining that under U.S. SEC rules, shareholders are only given an opportunity to vote for nominees presented by the company).

[70] *See id.* at 940-41 (discussing the process by which shareholders can nominate candidates).

[71] *See* Gerard V. Mantese & Ian M. Williamson, *Fiduciary Duties In Business Litigation*, Mich. B.J. 30, 30 (Aug. 2014) (discussing the fiduciary duties that all fiduciaries are held to, and after becoming a board member, the new nominee would be a fiduciary and held to the same duties).

best interests.[72] Thus, so long as these nominee directors, like the other company-appointed directors, are independent from the management and have interests that are aligned with the shareholders, they should be deemed independent as per the notion of independence that exists presently.

This begs the question of whether there is a need to re-examine the statutory contours of 'independence' and if it is possible to formulate an all-inclusive definition for independent directors. It does not seem feasible to exhaustively define the independence of a director *ex ante*; there will always be room for scrutiny *ex post*. It is important to note that it is finally the board of directors who approve the appointment of an independent director on a company.[73] It is their duty to go beyond the regulator-prescribed criteria of independence and make sure that the selected outside directors are free from any extraneous influential considerations, likely to tarnish their independence and bring them under the scanner.[74] Under the rubric of the Dodd-Frank Act of 2010, NYSE and NASDAQ have implemented new rules, which came into effect as of July 1, 2013, requiring compensation committees of public companies to be *only* composed of independent directors.[75]

Hedge fund activism has thrown up in sharp relief a new set of issues relating to independence of nominee directors. The existing *ex ante* definition does not address director independence in this context. Whether affiliation with shareholder groups can tarnish the impartiality and disinterestedness of a director has not yet been statutorily encapsulated. Whether directors are now required to be independent of shareholder or shareholder groups, in addition to being independent of the management needs regulatory clarification. Currently, this legislative vacuum is the question that should be answered.

---

[72] *See In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275, 289-90 (Del. Ch. 2003) (explaining that the director had a fiduciary duty to act in good faith in the corporation's best interests).

[73] NYSE, Inc., *supra* note 62, § 303A.02(a)(i).

[74] *See Corporate Governance Guidelines*, LOCKHEED MARTIN (Jan. 29, 2015), http://tinyurl.com/jm45rj7 (explaining standards of independence, in addition to the NYSE's standards, the corporation's board must use in determining independence).

[75] These new NYSE rules require the board to consider "all factors" relevant to determining independence for the purposes of executing the functions of the compensation committee. NYSE, Inc., *supra* note 62, § 303A.02(a)(i). Though not explicit, this change could be an indication that the exchanges might also start acknowledging the non-pecuniary, yet material factors influencing board neutrality, especially in light of the judicial development in this area.

B. *Why Special Compensation Enhances Independence In Nominee Directors*

There has been a specific objection raised as to the nature of compensation that was awarded by Jana and Elliott to their nominee directors. The exclusive cash compensation paid to the shareholder nominee, ahead of his election to the board, has not been the subject of debate. It is the special compensation that was offered to such director, conditional upon firm performance that attracted some dissidence.[76] This form of performance-based compensation is not new-fangled; companies have commonly used this model of compensation to remunerate their executives.[77] However, when the same is offered by these hedge fund shareholders to their nominees, it is alleged to have impinged the independence of the board.[78] This reaction seems to suggest that the consequence of such compensations when offered by the company to its executive staff and the members of the board is different from when they are offered by shareholders to their nominees. Before commenting on the consequence of such special compensation, I would like to analyze the purpose of such structures.

The underlying reason for companies to compensate their executives with performance-based incentives is to make sure they have a skin in the game, which would thereby align their interests with the interests of the shareholders.[79] This gives rise to an expectation that with their compensation dependent on stock performance of the company, the executives would be more cautious in their decision-making for the company.[80] The reasoning is the same for company determined performance-based compensation for the board of directors.[81] In view of this context, when similar packages are offered by hedge fund-

[76] *See* Matteo Tonnell, *Activist Hedge Funds, Golden Leashes, and Advance Notice Bylaws*, HARV. LAW SCH. FORUM ON CORPORATE GOVERNANCE & FIN. REGULATION (Jan. 7 2016), http://tinyurl.com/hbl8of7 (explaining that special compensation arrangements have ignited much debate).

[77] *See* Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. PA. J. LAB. & EMP. L. 227, 227-28 (1999) (explaining that performance based compensation is increasingly common).

[78] *See* Tonello, *supra* note 82 (discussing that a concern related to performance-based compensation is that it compromises the board's ability to be independent).

[79] Alex Edmans, *Performance-Based Pay for Executives Still Works*, HARVARD BUSINESS REVIEW (Feb. 23, 2016), *available at* http://tinyurl.com/p4p199 (explaining that "[t]he flipside of rewards for good performance is they allow punishment for poor performance – but a CEO with a fixed salary gets off scot-free even when shareholders are suffering.").

[80] *Id.*

[81] *See* Stabile supra note 77, at 227-228.

shareholders to their nominees, they are made out to be predisposed.[82] These packages make the compensation payable to the nominees based on how the company performs.[83] But, in addition to the incentive that exists when the company uses this structure of remuneration, hedge fund shareholders have another and a more important objective to achieve with such payment structures. It is essential that the slate of candidates put up by the dissidents should be of a standard comparable to, or better than, that of the incumbents, in order to convince shareholders of their candidacy. For this purpose, having a slate of candidates, who willingly accept a compensation contingent on the firm's performance, indicates the confidence that they have in the firm and their capabilities to ensure sustained growth for the firm. An incentive pay based on stock-price appreciation gesticulates the nominees' belief in the firm's performance. Unlike incumbents, who are known to have sufficient knowledge and expertise in governing the company and its policies, shareholders may often have inadequate knowledge about the candidates of the hedge fund shareholders, or insufficient awareness regarding their abilities.[84] Having compensation arrangements of the kind discussed above, play a dual role of not only incentivizing such candidates, but also enabling such hedge funds to signal their candidates' commitment to take the company forward.

V. DEBUNKING CLAIMS OF CORPORATE SHORT-TERMISM

Shareholder myopia or short-termism is a popular allegation made against activist shareholders. 'Short-termism' refers to management decisions that pursue immediate profits but reduce the firm's long-term value.[85] Activist shareholders like hedge funds are purported to hold stock in a company for a short duration, during which they actively try and improve the stock prices, so that they can sell and exit at a profit.[86] Such rapid trading is alleged to have diminished the breed of long-term shareholders and contributed to long-term costs to the company.[87] Despite these theories surrounding the ill-effects of hedge fund activism,

---

[82]Matteo Tonello, *Activist Hedge Funds, Golden Leashes, and Advance Notice Bylaws*, HARVARD LAW SCHOOL FORUM (Jan. 7, 2016), *available at* http://tinyurl.com/hbl8of7.

[83]*Id.*

[84]*See generally* Minor Myers, *The Perils of Shareholder Voting On Executive Compensation*, 36 DEL. J. CORP. L. 417 (2011).

[85]Dean Krehmeyer, Matthew Orsagh, & Kurt N. Schacht, *Breaking the short-term cycle* at 3 (2006), *available at* http://tinyurl.com/fn-tfel.

[86]*See, e.g.*, Daniel M. Gallagher, *Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors' College* (June 23, 2015), U.S. SEC, at n.15 *available at* http://tinyurl.com/sec-mals.

[87]Krehmeyer, *supra* note 86, at 11.

the reality shows that companies targeted by activist hedge funds have positive returns on an average over three years, following the fund's acquisition of the stock.[88] Studies have disproved that activist hedge funds are short-term investors who extract cash and exit immediately.[89] More importantly, these special interest shareholder groups form the minority in the corporation; they could only gain real power over management if they can persuade the dispersed shareholder base, usually the majority, to support them.[90]

These claims disregard the fact that institutional shareholders and hedge funds balance one another in a corporation. The next section of the article discusses how hedge funds play the gap-filling role in corporate governance. One of the primary reasons why investors view hedge fund intervention as adding value to the stock is because hedge funds react to the failure of other institutions to exercise their franchise for the benefits of all shareholders.[91] While institutional investors specialize in portfolio management and assessing competing value generating proposals, hedge funds complement these rationally reticent investors by identifying governance shortfalls and proactively engaging in framing performance related changes.[92] Thus, they mutually coexist, for the hedge funds would not be successful in their aggressive strategies without the support of the institutional investors.

The OECD research paper on Corporate Governance, Value Creation and Growth: The Bridge Between Finance And Enterprise has negated each of the following presumptions: (i) long-term is good, short-term is bad; (ii) long-term shareholder is long-term value creation for the company; and (iii) a long-term shareholder is an engaged shareholder.[93] While high-frequency trading causing volatile price fluctuations might be an inaccurate representation of actual price of the stock, as discussed above, not all long-term shareholders are engaged in an active dialogue with the management.[94] Thus, a mixed shareholder base, with activist

---

[88] Chris Clifford., *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 4 J. CORP. FIN., 323-336 (2008).

[89] *See* William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L. J. 1375, 1409-10 (2007); Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729-31 (2008).

[90] George W. Dent, *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 119 n.90 (2010).

[91] *See* Andrea Zanoni, *Hedge Funds' Empty Voting in Mergers and Acquisitions: A Fiduciary Duties Perspective* at 15 (2009), *available at* http://tinyurl.com/htkbxxq.

[92] Alessio M. Pacces, Presentation of *"Exit, Voice, and Loyalty from the Perspective of Shareholder Activism in Corporate Governance"*, Naples, XI Annual Conference of the Italian Society of Law & Economics, (Dec. 18, 2015).

[93] MARCO LANGENDOEN, LONG-TERM OR SHORT-TERM SHAREHOLDERSHIP: DOES IT REALLY COUNT? 51-52 (Corporate Governance, OECD publication 2012).

[94] *Id.*

investors contributing to the liquidity and marketability of the company's stock and other institutional investors providing the much-needed stability, is a best solution.[95]

Bebchuk, Brav and Jian studied the effect of hedge fund activism on stock price of firms over a period of five years following the initial intervention.[96] Their conclusions find no support for the claims that the presence of active hedge funds in a company fails to appreciate the long-term value of its stock.[97] Instead, they find that the initial pump in the prices is not upturned in the long-term.[98] They also find that the stock price is not negatively affected three years following the exit of the hedge funds from the company.[99] The proponents of board insulation from shareholder activism have countered the significance of this empirical data on the basis of their experience in dealing with firms, but have failed to substantiate their rebuttal with cogent evidence to the contrary.[100] Assuming that activist shareholders have a short-term focus and seek short-term value in stocks, the advocates for board insulation do not have any evidence proving that: (i) the actions undertaken by activist shareholders cannot have positive long-term consequences; (ii) activist shareholders actively avoid actions with long-term consequences; and (iii) both, short-term and long-term value enhancing measures are necessarily inconsistent.[101] It is important to note that inherent limitation in expertise and information asymmetry impedes their pursuit for long-term payoffs. As per the study conducted by Bratton, except for a few, most activist investors do not just extract cash and exit immediately from a firm.[102] More recently, Gow, Shin and Srinivasan have examined the determinants and consequences of hedge fund activism.[103] They have found that activists hold stock in a firm on an average for about 2.4 years, when their demands do not include board representation, and 3 years in case they obtain board representation.[104] The authors point out that a 3 year holding period would make such activists 'long-term'

---

[95] *Id.*

[96] *See generally* Lucian A. Bebchuk, Alon Brav, Wei Jiang, *The Long-Term Effects Of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015).

[97] *See id.*

[98] *Id.* at 1130.

[99] *Id.* at 1131-34.

[100] Martin Lipton, *Do Activist Hedge Funds Really Create Long Term Value?*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE AND FIN. REG. (July 22, 2014), http://tinyurl.com/m4jo953.

[101] *See* Bebchuk, Brav & Jiang, *supra* note 96.

[102] William W. Bratton, *Hedge Funds and Governance Target*, 95 GEO. L. J. 1375, 1409-10 (2007).

[103] *See* Ian D. Gow, Sa-Pyung S. Shin, Suraj Srinivasan, *Activist Directors: Determinants and Consequences*, 14-120 HARV. BUS. SCH. 1 (2014).

[104] *Id.* at 5.

investors, as the typical duration of even institutional investors like pension funds, on an average, does not exceed two years.[105]

In his seminal piece, Professor Roe rightly remarks that short-termism arises inside the corporation, and this gets further exacerbated when boards are insulated from shareholder influence.[106] The managerealistic view of short-termism held by the business industry and the courts alike is flawed because it overlooks the findings that compensation packages for the management and board are shorter than the holding period of hedge funds.[107] If duration of stay in the corporation is the sole criteria to determine the impact of the corporate player, the manager-director class could be considered more myopic than activist hedge funds. It appears that arguments of corporate short-termism have been advocated against hedge funds not so much for its implications on the performance of the company, but as a pretext to insulate the board from being challenged and replaced by the shareholders.[108] While the board should be shielded from the constant threat of displacement, in order for it to proficiently exercise its corporate functions, indefinite insulation poses a higher risk to the company and its shareholders in the short and long run, than the influence of activist shareholders on its management.

VI. IN DEFENSE OF ACTIVIST HEDGE FUNDS

It would be accurate to say that no day goes by without a mention of 'hedge funds' in our business and financial dailies. With hedge funds having taken up the reins of disciplining corporate boards and management, today they are considered the "swarms of locusts that fall on companies, stripping them bare before moving on."[109] While the hedge fund backlash continues to be the darling of the legal and business circles, the active posture of hedge funds in corporate governance and control cannot be discounted. Tracing the genesis of hedge fund

---

[105] *Id.*

[106] *See* Mark Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 977 (2013). Professor Roe argues that short-termism cannot be the reason for the boards to demand insulation from shareholders. Whether board merits insulation should stand or fall independently.

[107] *Id.*

[108] *Id.* at 982.

[109] Alexandros Seretakis, *Hedge Fund Activism Coming to Europe: Lessons from the American Experience*, 8 BROOK. J. CORP. FIN. & COM. L. 438, 441 n.16 (2014). The description of hedge funds as "swarms of locusts" belongs to the former Chairman of the Social-Democratic Party of Germany Frank Muntefering following the collapse of the takeover bid for the London Stock Exchange by Deutsche Boerse, caused due to the aggressive revolt by U.K-based hedge fund, The Children's Investment Fund.

activism, Part A of this section underscores the gap-filling role assumed by hedge funds as monitors of managerial discretion. It depicts that due to divergence in objectives and agency costs of agency capitalism, institutional investors have failed to be robust gatekeepers of the corporation.[110] Instead, they consider hedge funds to be efficient initiators of change. With their expertise, institutional investors undertake cost-benefit analysis and support the most viable proposals of hedge funds.

Section IV of this article proposed the fact that compensating nominee directors of activist shareholders does not violate any law promulgated by the legislature or any wing of the executive. Independence of the board is required to measure apropos of the management of the company and not the shareholder or shareholder group. However, opponents of special compensation awarded by activist shareholders to their nominee director candidates believe that such an outside third party remuneration mechanism, which is tied to the performance of the company, prejudices the objectivity of such nominees. They contend that the recurrent high payments made by such shareholder groups are tantamount to bribes, for the latter to represent such shareholder groups and act in their interest, while making board decisions. Thus, there is an underlying presumption of a divergence in the interests and goals of shareholders, which is the concern behind permitting such activists to personally recompense certain board members. Part B of this section demystifies this presupposition and proves that shareholders have a unity of interest, overpowering their otherwise dissimilar goals.

A. *The Gap-Filling Role of Hedge Funds*

The principal-agent model of governance, put forth by Michael C. Jensen and William H. Meckling and the agency costs associated with this model have come to dominate our understanding of the corporation.[111] The problems emanating from the separation of ownership from control can be traced back to Adam Smith, who didn't believe that directors did enough, looking after the wealth of passive shareholders.[112] The recent years saw the birth of institutional investors

---

[110]*See* Ronald J. Gibson & Jeffery N. Gordon, *The Agency Costs Of Agency Capitalism: Activist Investors And The Revaluation Of Governance Rights*, 113 COLUM. L. REV. 863, 863 (2013).

[111]Michael C. Jensen & William H. Meckling, T*heory of the Firm: Management Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976).

[112]*Id.* at 327.

like mutual funds, insurance companies, owning concentrated blocks in public companies.[113] They were positively perceived as long-term shareholders of the company, and were expected to maintain communication and effectively monitor the company's management on a sustained basis.[114] However, the financial crisis of 2008 indicated otherwise. It was a revelation of the inadequacy in the corporate governance arrangements and weaknesses of board composition and competence, which resulted in a failure of the corporate risk management systems.[115] Increases in executive compensation and lack of board oversight were some of the core reasons that contributed to governance failures.[116] Impassiveness amongst long-term institutional investors contributed to this systemic failure.

At this point, we must acknowledge that institutional investors are agents, who hold shares on behalf of individual retail shareholders.[117] As a result, there is a two-level agency relationship in a corporation—one between the owner shareholders and the management, and the other between the institutional shareholders and their beneficial holders, which creates agency costs of agency capitalism.[118] This is the root cause of deterrence for institutional investors to incur costs and engage in activism; they are 'rationally reticent' and tend to respond to, but not propose governance proposals.[119] Some jurisdictions have tried to address this agency problem by advocating a set of governance codes for encouraging institutional investors to play an activist role.[120] However, with the issue of free-riding permeating in the system, these institutional investors lack the motivation to serve the role of active monitors, mainly because they do not stand to personally benefit, over and above the value addition they bring for *all* the shareholder beneficiaries.[121] Thus, doubts

[113] *Id.* at 354.

[114] *See* OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*, at 50 (June 2009) (discussing the increase of institutional shareholders), *available at* http://tinyurl.com/jqdb9sj.

[115] *See id.* at 45 (explaining the importance of board composition).

[116] *Id.* at 12.

[117] OECD, *The Role of Institutional Investors in Promoting Good Corporate Governance*, CORPORATE GOVERNANCE REPORT, at 9 (Nov. 25, 2011).

[118] Gibson & Gordon, *supra* note 110, at 865.

[119] *Id.* at 867.

[120] The European Union, United Kingdom, Japan, Australia, Malaysia and Israel are some of the jurisdictions, which have taken steps towards initiating and introducing a similar model of communication; *see also* Gilson & Gordon, *supra* note 111, at 916-17.

[121] Simon Wong, *How institutional investors should step up as owners*, McKinsey and Company (Sept. 2010), available at, http://tinyurl.com/Pu239-U235.

are cast on whether these long-term institutional investors could be relied on as efficient gatekeepers of corporate policy.[122]

Unlike institutional investors, hedge funds have been proactive in pursuing corporate change.[123] Hedge funds emerged as aggressive byproducts of the financial catastrophe.[124] They claimed themselves to be capable of increasing shareholder value and serving as efficient managerial monitors.[125] Hedge funds are investment vehicles that pool investors' money and invest the same in productive, return enhancing ventures.[126]

Though hedge fund investment activity is similar to that of mutual funds, they face fewer regulatory restrictions.[127] They generally target underperforming companies and criticize their business plans, demand shareholder maximize corporate actions from management, recommend changes in the company's policies and practices, and also replace existing directors.[128] The hedge fund's self-interest in reaping profits by initiating shareholder-conducive proposals is the key driver for maintaining a constant vigil on the regulation of the company and ensuring its growth.[129] Thus, as agents of corporate change, hedge funds play a critical gap-filling role in corporate governance.

B. *Unity of Interest of Shareholders*

Some financial economic theorists believe that different shareholder classes have their differences over time horizons, risk preferences, and expectations from their investment.[130] Particularly, this view is held by those who believe in information asymmetry and in

---

[122]Mahdi Salehi, Mohmoud Hematfar and Amin Heydari, *A Study of the Relationship Between Institutional Investors and Corporate Value: Empirical Evidence of Iran*, 8 MIDDLE-EAST J. SCI. RES. 72, 73 (2011).

[123]Marcel Kahan, and Edward B. Rock, *Hedge funds in corporate governance and corporate control*, 155 U. PA. L. REV. 1021, 1029 (2007).

[124]Laurence Fletcher, and Tommy Wilkes, *Analysis: Hedge funds enjoy post-crisis popularity with 'safe' image*, REUTERS MONEY (Sept. 17, 2013), http://tinyurl.com/Pb-Pu-238.

[125]*Unlocking value: the role of activist alternative investment managers*, ASSET MANAGEMENT REPORT, at 7 (Feb. 25, 2015), http://tinyurl.com/U238-Pb.

[126]*Hedge Funds*, INVESTOR BULLETIN (SEC, Washington, D.C.), at 1.

[127]The U.S. Securities and Exchange Commission, *Fast Answers–Hedge Funds* (Dec. 4, 2012), http://tinyurl.com/zn768.

[128]*The Activist Revolution- Understanding and Navigating A New World of Heightened Investor Scrutiny*, J.P. MORGAN, at 7 (Jan. 2015), http://tinyurl.com/hjfzdmv.

[129]*See* Daniel M. Gallagher, SEC Commissioner, *Activisim, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors' College* (June 23, 2015); Mark Boucher, *The Hedge Fund Edge* 44 (1999).

[130]Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 368-70 (1991).

inefficiency of the stock markets.[131] According to them, this disparity in expectations is the genesis of a conflict of interest amongst them,[132] which could be dangerous,[133] and such "competing interests [] may conflict with the best interests of the public corporation, [] its [entire] shareholder body and other constituencies taken as a whole."[134] It cannot be denied that due to the different expectations of various shareholders in a corporation their objectives might not be completely streamlined. For example, evidence suggests that employee-shareholders follow voting patterns that reflect their interests as employees rather than just as shareholders of the company.[135] Similarly, pension funds are known to have political agendas that could outweigh their interest in shareholder value maximization.[136] Also, shareholders could be apathetic or uninformed and not very keen on maximizing shareholder value; or shareholders who are also holding debt securities in the company could be risk averse and not support risky ventures, which otherwise could be profit enhancing. In such situations, bestowing matters requiring majority or super-majority shareholder approval in the hands of a diverse group of shareholders could seem precarious. However, despite these differentiations, as per the neoclassical economic theory, shareholders generally only hold stock if the expected returns offset the cost.[137] The sole end of a business is creating profits for its shareholders.[138] Shareholders are viewed as a "single economic abstraction, rather than as a group of embodied individuals with varying goals."[139] Shareholders are bound by the pursuit of the common goal of maximizing the price of

---

[131]Bolos Marcel, Tudor Ortan, & Cristian Otgon, *Information Asymmetry Theory in Corporate Governance Systems,* 516, 516 (Issue 2, 2010).

[132]Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577-93 (2006).

[133]*See* Stephen Bainbridge, *Can Corporate Directors Take Third Party Pay From Hedge Funds?*, PROFESSORBAINBRIDGE.COM (Aug. 4, 2013), http://tinyurl.com/ht83w86.

[134]Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come,* 59 BUS. LAW. 67, 78 (2003).

[135]*See* Ashwini K. Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence From Proxy Voting,* REVIEW OF FINANCIAL STUDIES (2008) (NYU Stem Working Paper Series Paper, No. Fin-08-006, 2008), *available at* http://tinyurl.com/SSRN-AKA.

[136]Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered,* 93 COLUM. L. REV. 795, 795-96 (1993); MICHAEL T. JACOBS, SHORT-TERM AMERICA: THE CAUSES AND CURES OF OUR BUSINESS MYOPIA 53 (Harvard Business School Press, 1991).

[137]Frank H. Easterbrook & Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 23, 29 (Harvard University Press, 1996).

[138]Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

[139]*See Should the SEC Expand Nonfinancial Disclosure Requirements?,* 115 HARV. L. REV. 1433, 1437-39 (2002).

the stock and improving performance of the company.[140] Different investment preferences need not affect their perception towards the company's business and profit-making strategy.[141] Despite criticisms for greater shareholder power, owing to their conflicting goals and lack of competency to play a valuable role in corporate governance, their power to vote on resolutions by majority support indicates the fundamental unity of shareholders.

VII. SPECIAL COMPENSATION: A THREAT TO BOARD COHESIVENESS?

One of the main objections to dissident nominee compensation by the nominating shareholder is that it would "creat[e] a multi-tiered, dysfunctional Board in which a subset of directors are compensated and motivated significantly differently from other directors;" and would result in "poisonous conflicts in the boardroom by creating a subclass of directors who have a significant monetary incentive to sell the corporation or manage it to attain the highest possible stock price in the short-run."[142] These are also the reasons identified in the Wachtell Memo for promoting the adoption of the Wachtell Disqualifying Bylaw.[143] The issue was intensified when the proxy firm, ISS, recommended the shareholders of Provident Financial Holdings, Inc., to withhold their votes from the three director candidates standing for reelection to the company's staggered board because the board adopted a bylaw designed to discourage special dissident compensation schemes.[144] ISS was criticized to be "unwittingly promoting fragmented and dysfunctional boards, conflicted and self-interested directors and short-termist behavior."[145] These compensation schemes have been carped by many from legal academia as well, with Professor Stephen Bainbridge of University of California, Los Angeles, saying, "[i]f this nonsense is not illegal, it ought to be,"[146] and Professor John C. Coffee, Jr. claiming that

---

[140]*Id.* at 1438 n.35.
[141]Dent, *supra* note 90.
[142]Lipton, *supra* note 5.
[143]*Id.*
[144]Berl Nadler, *ISS Advises Against By-Law Restricting Shareholder Compensation of Board Nominees*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Dec. 27, 2013), http://tinyurl.com/h3ceete.
[145]Martin Lipton, *ISS Addresses Dissident Director Compensation Bylaw*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Nov. 21, 2013), http://tinyurl.com/j5guhwg.
[146]Stephen Bainbridge, *Can Corporate Directors Take Third Party Pay From Hedge Funds?*, PROFESSORBAINBRIDGE.COM (Aug. 4, 2013), http://tinyurl.com/ht83w86.

such "[t]hird-party bonuses create the wrong incentives, fragment the board, and imply a shift toward both the short-term and higher risk."[147]

Differing incentive arrangements in proxy contests have been alleged to create "two classes" of directors, purported to threaten board cohesiveness and sow dysfunction therein.[148] This, by far, has been the most bizarre claim made by opponents of third-party special compensation for board nominees. Before countering these claims, it is necessary to briefly analyze how compensation for the board of directors of a company is determined. Members of the board set their own compensation; thus there exists an inherent conflict of interest surrounding this issue, which calls for greater scrutiny of the procedure and manner of arriving at such compensation.[149] Boards generally engage an independent compensation consultant for the purposes of collating and studying data on the market trends and advising on compensation related issues.[150] Also, listed public companies are mandated to have a compensation committee, which determines the compensation for its executive and non-executive directors.[151] The compensation committee is also required to be composed of independent board members. The executive compensation determined by the compensation committee would then be subject to shareholder say-on-pay. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requires public companies to allow shareholders a non-binding vote on the frequency of say-on-pay votes, *i.e.*, every one, two or three years.[152] Additionally, Dodd-Frank requires companies to hold such votes on the frequency of say-on-pay votes at least once every six years.[153] However, unlike executive compensation, board compensation is solely decided by the independent compensation committee; shareholders do not have a binding or non-binding say on the same.[154]

Board compensation is generally structured as a mélange of one or more of the following forms of payment: annual cash retainers, meeting fees, committee retainer and fees, stock options and full-value stock

---

[147] Coffee, *supra* note 8.

[148] Adam Prestidge, *Activist Compensation of Board Nominees and the Middle Ground Response*, 11 HASTINGS BUS. L.J. 307 (2015).

[149] *Client Alert: Director Compensation in Turbulent Times*, GIBSON DUNN (May 1, 2008), http://tinyurl.com/GD-DCTT.

[150] *Id.*

[151] *See* N.Y.S.E., *Listed Company Manual*, Rule 303A.05, *available at* http://tinyurl.com/j9geqb8 (last visited Apr. 23, 2016); N.A.S.D.A.Q., *Marketplace Rules*, Rule 5605(b)(1), *available at* http://tinyurl.com/h94afa6 (Apr. 23, 2016).

[152] 15 U.S.C.A. § 78n-1.

[153] *Id.*

[154] 15 U.S.C.A. § 78j-3.

awards.[155] A recent study conducted by Professor James Linck, with Professor Viktar Fedaseyeu and Professor Hannes Wagner, put together a dataset of over 57,000 board positions from 2006 to 2010 and found that "compensation of outside board members . . . varies significantly across board members, even within the same firm."[156] The study disproves the presumption that all outside directors on board of a company are paid the same; finding that within the same board, the difference between the highest and lowest paid director on a board averages $186,000.[157] Thus, it appears board members are not paid uniform salaries. The form of compensation and prevalence of such variance has never been raised as a concern until activist shareholders proposed to pay special compensation packages to their nominees.

Moreover, the special compensation structure adopted by activist shareholder Jana, by linking the compensation of its nominee to the performance of the company, is a very common occurrence in the private sector.[158] This is analogous to the structure adopted by private equity funds investing in private corporations.[159] One of the quintessential control rights negotiated by private equity funds is the practice of having their representatives on the board of the company, as well as compensating them with bonuses based on the performance of their investment in the company.[160]

The concept of proxy fight was encapsulated in corporate law principles because shareholders have been considered to be competent to decide their directorial candidates, to manage and govern the corporation.[161] If they have been empowered with such a vital decision-making clout in the corporation, there is absolutely no rational basis to exclude certain directorial candidates based on the source of their pay from contesting, thereby fiddling with shareholder choice. Should the shareholders believe that the compensation for such nominees is too high or is not commensurate to their qualifications or potential, they could and

---

[155]*See* Viktar Fedaseyeu, James S. Linck & Hannes F. Wagner, *The Determinates of Director Compensation*, VILL. DEPT. OF FIN. 13, 32-33 (Feb. 14, 2014), http://tinyurl.com/VLS-Board (discussing the various types of compensation the board of directors receives from a company).

[156] *Id.* at 1.

[157]*Id.* at 20.

[158]*See* Edward M. Iacobucci, *Special Compensation Arrangements For Dissident Directors In Proxy Contests: A Policy Analysis*, U. TORONTO L. WORKING PAPER SERIES NO. 2014-01 3 (Dec. 18, 2013), http://tinyurl.com/UT-1812.

[159]*Id.* at 22-23.

[160]*Id.*

[161]*See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 413-24 (2006-2007) (explaining the rights of shareholders including: right elect directors, right to receive distributions, right to vote on fundamental issues, and the right to some information about the corporation.).

would express their view through the ballot, in an absolutely democratic process. Therefore, the argument that varying levels of exposure to the same benefit creates opposing viewpoints amongst board members is patently ludicrous. Instead, as both, the incumbent and dissident would want their candidates to be elected, there is an endeavor towards dissemination of more information to the shareholders. Thus, the differential pay amongst board members in effect, fosters greater transparency in the system. Moreover, if in a proxy fight the incumbent board does get replaced by the dissident slate (being offered such additional compensation by third parties), it could be an important signal of incumbent board underperformance being linked to an incorrect structuring of the compensation and a need for making amends to the same.

Nevertheless, if "board balkanization" is considered a serious threat to board cohesiveness,[162] there is no reason why the full board cannot adopt similar incentives. There are definitely other ways to deal with this supposedly Machiavellian practice; precluding such candidates from contesting is not the solution.

The next section of this article claims that prohibiting special compensation for activist nominees would deter, rather than motivate them in pursuing their value-creating function in the company. A hedge fund nominee's ability to act objectively and independently from management and the company's performance is directly proportional to the remuneration offered to him. As discussed in Section VI.A above, a hedge fund's self-interest is the key driver for it to maintain a constant vigil on the regulation of the company and ensure its growth. This can be achieved by balancing the inevitable hedgehog's dilemma and hence the following section would propose some tweaks to the remunerative mechanisms adopted by hedge funds for paying their nominee directors. These would include lengthening the duration of measuring the director's performance, capping the size of the incentives, altering the timing of their disbursement and suggesting a payoff schedule, which is a combination of cash compensation and alternative instruments like stock options, restricted stock and the like, for achieving an ideal remuneration structure for hedge fund nominees and bringing about effective corporate governance.

---

[162] *See* Iacobucci, *supra* note 158, at 25.

VIII. REFORMULATING THE ALLEGEDLY MACHIAVELLIAN DISSIDENT DIRECTOR COMPENSATIONS AND RECOMMENDATIONS

> "The trade-offs of becoming a director of a corporation don't look nearly as attractive these days. The compensation hasn't gone up that much, the hours have gone up a lot and liabilities have increased."[163]
> —John A. Thain, CEO, New York Stock Exchange

Based on the premise of the resourceful, evaluating, maximizing man (REMM),[164] agency theory suggests that directors and managers will always try to maximize their own welfare, which may diverge from the interests of their shareholders.[165] Agency costs are a consequence of such divergence. They primarily comprise the costs of monitoring and incentivizing.[166] One of the solutions to this principal/agent problem was to install a board of directors that would act as an intermediary between owners and management, thus monitoring management and taking action where appropriate to the benefit of the owners. Initially, corporations were owned by a few shareholders, who also used to control the appointment of directors. Thus, the board was aligned with shareholder interests. The phenomenal growth of the American economy saw a gradual transition towards diffused ownership and control of the corporation came under the management of the shareholder based widened and the existing board members were replaced by independent outside directors, who owned little to no equity in the company and thus had no personal financial stake in rendering board services.[167] It was found that compensation is required to entice independent directors to expend their time and effort in such role.[168] This was when the Model Business Corporation Act (Model Act) was amended, in 1953, by the Committee on Business Corporations of the American Bar Association and authorized board of directors to set their own compensation, unless

---

[163] Anita Raghavan, *More CEOs Say 'No Thanks' To Board Seats*, WALL ST. J. (Jan. 28, 2005), http://tinyurl.com/WSJ-970.

[164] *See* M.C. Jensen and W.H. Meckling, *The Nature of Man*, 7 J. APPLIED CORP. FIN., at 34 (1994).

[165] *See id.* at 32-33.

[166] *See id.*

[167] Lilia Volynkova, Seinfeld v. Slager*: The Delaware Chancery Court's New Legal Standard for Reviewing Directors' Decisions About Their Own Pay*, 58 N.Y.L. SCH. L. REV. 741, 744 (2013-2014).

[168] *See* Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 130-33, 139-40 (1996) (discussing how compensation is necessary to retain top tier directors).

the articles of incorporation or bylaws provided otherwise.[169] Conventionally, directors used to be exclusively paid in form of cash payments, as annual retainers, meeting fees and cash bonuses.[170] However, in order to overcome, or at least mitigate conflicting interests between shareholders and the directors, performance-based compensation is one of the chief mechanisms that has been increasingly adopted by corporations.[171] They are believed to be an effective incentive to induce managers to make *a priori* decisions that are in the shareholders' best interests.[172] Currently, directors are usually paid some part of their compensation in fixed cash and the remaining could be immediate or deferred.[173] It could either be immediate cash payments, or deferred cash payments, payments into bonus bank, phantom stock or stock appreciation rights, or restricted or unrestricted stocks or options.[174] The main objective of having a component of variable compensation in the compensation structure is to shift the business risk to the directors and to achieve the alignment of interests of the board and the shareholders.[175]

While the quantum and manner of determining board and executive compensation by the company have been subjects of shareholder litigation in the past, with the company and its compensation committee being subjected to various standards of judicial review, none of those cases involved the compensation being decided by a party other than the corporation or its delegated authority. As discussed in Section II of this article, activist shareholders, Jana and Elliott structured a performance based compensation structure for their nominees on boards of Agrium and Hess, respectively. According to these activist hedge funds, poor compensation practices and failing to align the board interests with company performance have resulted in weak corporate governance and sustained underperformance.

---

[169] *See* Model Business Corporation Act § 8.11 (2002). Many states in the United States have adopted the Model Business Corporation Act.

[170] *See* Elson, *supra* note 168, at 162, 173.

[171] *See* Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. PA. J. LAB. & EMP. L. 227, 229-30, 237-38 (1999-2000) (discussing how "[p]erformance-based compensation is seen as a means of providing incentive for executives to perform in ways that maximize corporate/shareholder wealth and/or as a way of paying executives commensurately with their contribution to a corporation's growth and performance.").

[172] *See* Lucian Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSPECTIVES 71, 73 (2003).

[173] *See* Elson, *supra* note 168, at 171-73.

[174] *See id.* at 171-72.

[175] *See id.* at 166-69.

Before analyzing different compensation structures, we could dissect the components of the compensation, which was agreed by the hedge funds for their nominee directors.[176]

Elliott's compensation structure for its nominee directors at Hess:[177]

- Pre-election Flat Fee: Before his election, Elliott's shareholder nominee would be paid a flat fee of $50,000.
- Post-election Bonus: Elliott's shareholder nominee, if elected to the board, would receive $30,000 for each 1% that Hess's stock outperforms it's own proxy peers as measured at the end of his three-year term as a director. Thus, each shareholder nominee receives compensation for three years only, to the extent that Hess's stock outperforms its peer group. For example, if Hess's stock outperforms its peers by 10% over the next three years, as per the terms of the compensation agreement, the shareholder nominee who served a full term would receive $300,000 (10 x $30,000).
- Compensation cap: There is a $9 million contractual cap in the compensation agreement. Hess would need to outperform peers by 300%, in order for the director nominee to achieve a $9 million payment.

The bonus payments agreed by Elliott have been a subject of several objections, specially that they would beholden the nominee directors only to Elliott, compromising on board independence (as discussed in Section IV of this article) and that they only cater to short-term share value, for they only contemplate the period of three years, thereby also incentivising such directors to take actions that could adversely affect the company in the long-term (as discussed in Section V of this article).[178] Despite these demurrals, Elliot's presentation to the shareholders of Hess clearly indicated that the bonuses offered were tailored to tie the payoff to Hess's stock price performance compared to competitors.[179] Here, the overarching incentive of the activist hedge fund

[176]Details of compensation agreed to be awarded by Jana and Elliot to their director nominees on boards of Agrium and Hess is based on information from public sources and media reports.

[177]*Elliott Management Releases Letter to Hess Shareholders*, BUSINESS WIRE (Mar. 26, 2013), http://tinyurl.com/hbqdux6; *see also* Cunningham, *supra* note 23.

[178]*See supra* Part V.

[179]*Elliott Management Releases Letter to Hess Shareholders*, BUSINESS WIRE (Mar. 26, 2013), http://tinyurl.com/hbqdux6.

is abundantly clear—to outperform the peer company stock price performance over three years.

Jana's compensation structure for its nominee directors at Agrium:[180]

- Pre-election Nomination Fee: Cash payment of $50,000 to be paid for time and expense of serving as nominees through the proxy contest including significant time travelling and meeting with shareholders and other interested parties in the US and Canada.
- Post-election Performance Based Incentive: Once elected to Agrium's board, these nominees were promised 2.6% of Jana's net profit, based on the performance of Agrium's share price.
- Even if not elected, they will still receive 1.8% of Jana's net profit.

A similar structure was observed when Carl Icahn raged a proxy battle against the management of Forest Laboratories, Inc. and offered his nominee on board of the company, Mr. Eric Ende, one percent of Icahn's profits over a certain share price, which carried a hefty premium, in addition to a monthly fixed fee.[181] What is common between the compensation packages offered by Jana and Icahn is that the nominee's payment depends not on the returns to the stock as a whole but on the hedge fund's profit. This was one of the most criticized aspects of such payment packages, primarily because it no longer aimed at aligning nominee director incentives to the performance of the company but hinged upon the profit making by the hedge funds.[182] Technically, the hedge funds would make profits and receive higher returns on investment only when the company performs well, and to that extent profits earned by hedge funds are directly proportional to the stock price of the company. However, linking a director's incentive pay to the profits of the nominating shareholder inevitably colors the arrangment with a very high liklihood of nepotism, suggesting such nominees to be on the leash of the hedge funds, thereby raising questions on their independence and competency to serve the company as a whole.

---

[180] *Agrium: A Better Way Forward, Presentation by Jana to Agrium's Shareholders*, AGRIUM (Jan. 2013), http://tinyurl.com/SHF-JANA.

[181] Letter from Forest Laboratories to its Shareholders (July 16, 2012), *available at* http://tinyurl.com/jc5caev.

[182] *See* Roe, *supra* note 106 at 977.

Shareholders' compensating their own nominees is not illegal under present law[183] and should not be *prima facie* labeled as iniquitous. It definitely does not warrant adoption of Wachtell-like bylaws, stripping the shareholders of their already constricted rights in a corporation. Nor can it be said that the incumbent board would have no concern having an activist shareholder nominating and compensating its director. Thus, the ideal time to focus on mitigating this risk is "on a clear day," well before any such concerns cause an unrest in the functioning of the corporation. One way the trepidations appurtenant to this practice could be lessened is by incorporating in the compensation packages of these nominee directors a set of soft, non-financial metrics of performance, coupled with economic parameters, so that the board is encouraged to focus not only on earnings *per se* but also on the quality of those earnings. This section of the article aims at designing a long-term incentive program for nominee directors, taking into account the various internal and external factors shaping the plan and effectiveness of its delivery. Before jumping the gun and formulating various alternatives, it is essential to list out the the goals sought to be achieved by determining director compensation.

Table 1 below lists the author's perspective of the possible key objectives of a compensation plan, alongside their priority. The level of importance attached to each of the factors below would differ across companies in different industries, and would largely depend on their maturity profiles and internal situation. Thus, one cannot adopt a one size fits all approach for identifying remuneration devices matching such priorities. The idea here is to have a preset list of considerations that can be referred to, while working on an optimal compensation structure of shareholder nominee directors.

---

[183] Adam Prestidge, *Activist Compensation of Board Nominees and the Middle Ground Response*, 11 HASTINGS BUS. L.J. 307, 309 (2015).

Table 1

Objective	Priority
Attract the qualified and competent candidates	High
Maximize stockholder value	High
Align the interests of the nominees with that of the company's objectives.	High
Nominees to focus on long-term value creation.	High
Maximize company cashflow	Medium
Retain the nominees for longer tenure.	Medium
Outperform competitors in the market	Low
Having a skin in the game.	Low

Based on the Compensation Governance Report, 2014 prepared by Shearman & Sterling (S&S Report),[184] the overall director compensation continues to comprise a mix of cash, equity and perquisites.[185] Table 2 is indicative of the popularity of the kind of director compensation amongst the Top 100 Companies in 2014.[186]

[184]The 12th Annual Survey, conducted by the law firm, Shearman & Sterling, reviewed the corporate governance practices of 100 of the largest US public, non-controlled US listed companies, selected on the basis of a combination of their latest annual revenues and market capitalizations, and referred to as the "Top 100 Companies." Data in this survey was collected from publicly available information as of June 1, 2014, http://tinyurl.com/70x1777 [hereinafter, S&S Report].

[185]*Id.* at 54.

[186]*Id.*

Table 2

Nature of Compensation	Companies in the Top 100 Companies having adopted Measure in 2014
Cash Retainers	98
Committee Compensation	96
Perquisites and Benefits	76
Deferred Stock Units	43
Restricted Units	41
Meeting Attendance Fees	22
Non-Restricted Stock	17
Stock Options	13

We see above that cash retainers, committee specific compensations, and deferred stock units are more popular amongst the Top 100 Companies, as compared to meeting fees, stock options and non-restricted stock. Components of benefits and perquisites could largely vary amongst companies from insurance to medical and dental benefits, use of company property, tax reimbursements etc, making it highly subjective. Hence, for the purposes of this article, benefits and perquisites would be excluded from the ambit of determining an optimal compensation arrangement for nominee directors. The predominant forms of long-term incentive awards are: shares, share units and stock options. Some of these awards are time-vested and some vest on the basis of performance.[187]

This segment will deal with the prime concerns raised pertaining to nominee director compensation and try to address them with possible recommendations, which could help mitigate them.

[187] Bebchuk, Brav & Jiang, *supra* note 96.

A. *Stock Ownership and Duration*

Director compensation has undergone substantial changes. Firstly, the overall level of compensation has increased and continues to increase; especially after the Enron debacle, restrictions have been imposed on the number of boards a director may serve, thereby snowballing their workload.[188] Also, changes in the accounting rules regarding equity-based compensation are impacting the type and form of equity awards companies use to compensate directors.[189] There is a consensus in the results of empirical research, which studied the relationship between directors' motivation and their pay, when it came to evaluating CEO performance.[190] It was found that the nature of the board member's decision-making differs depending on the compensation structure; directors who receive stock as compensation use quantitative, verifiable criteria to measure CEO performance.[191] Whereas, those who are paid in cash, make greater use of the qualitative measures in assessing CEO performance.[192] It was found that firm performance has a significant negative correlation with qualitative measures.[193] This suggests that equity ownership is essential to align the board's interest with that of the shareholders.[194] Thus, boards with significant stock ownership are more likely to maintain a stronger link between CEO compensation and firm performance. Directors' contributions to corporate wealth are greater at higher levels of ownership.[195]

As discussed in Section V of this article, one of major criticisms faced by dissidents and their nominee directors is that they do not think about long-term value creation for the company.[196] Most so-called

---

[188]Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 WIS. L. REV. 795, 804 (2005).

[189]James F. Reda, Stewart Reifler, & Laura G. Thatcher, THE COMPENSATION COMMITTEE HANDBOOK, 82 (New York: Wiley, 3d ed. 2008).

[190]P. Silva, *Do Motivation and Equity Ownership Matter in Board of Directors' Evaluation of CEO Performance*, 17 J. Managerial Issues 346-62 (2005); Benjamin E. Hermalin, & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance, Financial management* 101-112 (1991); Jeffrey L. Kerr, & Leslie Kren, *Effect of Relative Decision Monitoring on Chief Executive Officer Compensation*, 35 ACAD. OF MGMT. J. 370-397 (1992).

[191]*See* Silva, *supra* note 190, at 346-362; Hermalin & Weisbach, *supra* note 190, at 101-112.

[192]*Id.*

[193]*Id.*

[194]Sanjai Bhagat & Heather Tookes, *Voluntary And Mandatory Skin In The Game: Understanding Outside Directors' Stock Holdings*, 18 EUR. J. FIN. 191 (2011).

[195]*Id.*

[196]*See* Bebchuk, Brav & Jiang, *supra* note 96, at 1134.

"long-term incentive compensations [are] not reward[s] for 'long-term' value creation;" most of such awards are stock-related (stock units or stock options) and are generally earned within one to three years.[197] However, it is important to note that "[w]hat constitutes 'long-term' for purposes of satisfying a sustained value requirement will vary depending on the perspective of the investor."[198] For example, a hedge fund will generally have a different time horizon for its investments in Facebook in comparison to that envisaged by Mark Zuckerberg. Moreover, the actual correlation between long-term incentive compensation and long-term investment performance is uncertain.[199] It is doubtful to expect a foolproof incentive plan for directors, designed to correlate with the company's economic performance over five to ten years.[200] Instead, the endeavor is to consistently motivate directors to ensure sincere sustained efforts towards achieving 'long-term' value enhancement.[201] For this purpose, companies could consider some of the strategies discussed in this section.

Some companies have stock retention requirements that require executives and directors to retain all or a portion of their shares acquired from awards of equity-based compensation for a specified time period.[202] "Thirty of the Top 100 Companies maintain director stock retention requirements;"[203] however the amount of equity subject to such requirements and the required retention periods vary significantly.[204] "Forty-three of the Top 100 Companies grant deferred stock units as a component of director compensation."[205] "[The] vesting periods for long-term incentive awards (whether based on time-vesting or performance-vesting) for executives are generally around three years."[206] In case of directors, "most of [their] compensation is a combination of cash-based fees and equity awards."[207] Such "stock awards (or the payment of cash in respect of the stock awards)" are usually delayed

---

[197]Joseph E. Bachelder, *Compensating for Long-Term Value Creation in U.S. Public Corporations*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Aug. 5, 2014), http://tinyurl.com/HLS-14viii05; *see* Bebchuk, Brav & Jiang, *supra* note 96, at 1087.

[198]*See* Bachelder, *supra* note197.

[199]*See id.*

[200]For the purposes of this article, we assume five years or more to be construed as a long-term period. Undertaking an empirical study or regression analysis to determine such period is beyond the scope of this article.

[201]*See* Bachelder, *supra* note197.

[202]*Id.*

[203]S&S Report, *supra* note 184, at 42.

[204]For example, directors might be required to retain 50% or 75% of their equity.

[205]S&S Report, *supra* note 184, at 42.

[206]Bachelder, *supra* note 197.

[207]*Id.*

until "a date later than the vesting date," and this is generally "until the individual director retires from the board."[208]

In the context of hedge funds remunerating their nominee directors based on such incentive compensation, they could consider the following suggestions:

Delaying the payout Firstly, they could replace vested cash payouts by vested equity compensation. Moreover, instead of distributing the equity awards within a year or less, payout could be delayed for an additional two years or longer, such that the actual payment is made five years after the original award date. Thus, if stock units were agreed to be vested in equal installments over a period of three years, the actual dispensation of the payments would be derailed further, until the fifth year after the grant of such award. The ISS board compensation guidelines include a vesting schedule or mandatory deferral period requiring the shares in payment of deferred units to not be paid out until the end of three years.[209]

Extending stock retention duration or delinking payout from the director's tenure On similar lines as the delay in payout, it is suggested that such compensation arrangements between the activist shareholders and their nominees contemplate extending the duration for holding the company's stock beyond the nominee director's retirement. Thus, in addition to delaying the payout for the equity based incentives, the directors should be mandated to hold a certain amount of stock in the company for a period of three to five years.[210] Such delinking of the compensation from the nominee's tenure in the company is particularly beneficial in companies with staggered boards, where the director's term is uncertain.

B. *Company Performance-based Compensation*

Performance based compensation generally refers to compensation, where payout only occurs if a performance goal is reached.[211] There are alternative approaches of performance

[208] *The 2013 Top 250 Report: Long-Term Incentive Grant Practices for Executives*, FREDERIC W. COOK & CO., INC. at 8, 10 (Sept. 2013), http://tinyurl.com/fwc-1519.

[209] *Director Qualification/Compensation Bylaw FAQs*, INSTITUTIONAL SHAREHOLDER SERVICES (Jan. 13, 2014), http://tinyurl.com/ISS-20CE.

[210] Recently, two nominees of the hedge fund Third Point LLC were elected on the board of Dow Chemical Co. Such nominee directors have been promised long-term bonuses by Third Point LLC based on the performance of the chemical company's stock over three and five years. *See* David Benoit & Joann S. Lublin, *Dow Chemical, Loeb Settle Board Dispute*, THE WALL STREET JOURNAL (Nov. 21, 2014), http://tinyurl.com/WSJ-3PLLC.

[211] *See* Bachelder, *supra* note 197.

measurement: company performance measured against long-term thresholds, targets, and performance goals; or against peer performance or on the basis of a performance index.[212] While some plans use an "all or nothing" approach to achieving a performance goal (for example, minimum award would be given if 80% of the goal is achieved, and a higher award if 100% is achieved), some plans reference to one or more performance metrics to determine the award (for example, when the award is a percentage of the revenue made by the company, and where such percentage escalates with the uplift in the revenue bracket).[213] An increasingly used performance metric is total shareholder return (TSR) (or relative TSR—meaning TSR compared with a peer group or an index).[214] Indexing of the performance goal is also used by some companies, on the theory that a company's performance must be compared with the performance of its competitors to determine true performance.[215] Thus, such cases use relative performance comparisons, to determine true underperformance or over-performance with respect to a defined market.[216] In some cases, with the hope to create and sustain 'long-term value', compensation committees use an economic criterion such as earnings per share or return on the invested capital.[217]

As discussed earlier in this section, one of the key reasons the compensation packages offered by Jana and Icahn to their respective nominee directors had become the epicenter of condemnation was because they were tied to the profits made by the hedge fund, and not to any performance metrics related to the company.[218] The backlash faced by this particular arrangement stemmed from the blatant nexus between the nominee's pay and the hedge fund's interests, thereby raising questions on the nominee director's conflict of interest and fiduciary duties.[219] Instead, companies could delink the vesting of awards and payouts with the hedge fund's stake in the company. This would ensure that the compensation arrangements between the hedge fund and the nominee do not depend on the hedge fund's plans vis-à-vis its stake in the company. This obviously suggests that nominee compensation cannot be conditional upon and limited to the possibility of profits being made by

---

[212] *See id.*

[213] *See The 2013 Top 250 Report: Long-Term Incentive Grant Practices for Executives*, *supra* note 207, at 9.

[214] Bachelder, *supra* note 197.

[215] Reda, Reifler, & Thatcher, *supra* note 189, at 229-30.

[216] *Id.*

[217] *Id.*

[218] *See infra* note 106 at 37-38.

[219] *Letter from Forest Laboratories to its Shareholders* (July 16, 2012), *available at* http://tinyurl.com/jc5caev.

such hedge funds. Rather, they could consider tying his remuneration to a market or sector index, to a group of competitors, or to the company's capital cost. Alternatively, it could be based on the achievements of certain performance targets (if the company's share price beats the market or basket of similar shares over a specified period) or company's profits. In such a case, the nominee, once elected to the board of the company, continues to serve as a director, fulfilling his obligations as one, even after the hedge fund exits the company. This would definitely strengthen the credibility of the nominee candidates and once elected as directors, they would less likely be subject to scrutiny and suspect.

C. *Bonus Payments*

The introduction to this section of the article underlined how the bonus payments made by the activist hedge funds to their nominees have been vigorously criticized as 'golden leashes', which are assumed to make directors beholden to the activist or "make decisions that create short-term stock gains but harm the long-term health of the company."[220] Activist shareholders, could instead, consider paying bonuses in stock or options. Alternatively, if such payments are made in cash, it is recommend to use phantom stock plans or a bonus bank concept.[221] A phantom stock plan is an employee benefit plan that gives selected employees or directors many of the benefits of stock ownership without actually giving them any company stock (also referred to as "shadow stock").[222] The document informs the employees of the starting value of the shares along with other conditions of the plan.[223] Upon fulfillment of the plan terms, the employees are eligible to receive a payment in exchange for their units.[224] The amount of the payment will depend upon (1) the number of vested units they hold, (2) the value of the units at the time of payment, and (3) whether the plan was for the full value of their units or strictly the appreciation in the value from the date of grant.[225] For example, suppose an employee received 10 phantom shares with a starting value of $5, and assume the shares are valued on the payment

[220]David Benoit, *ISS Open to Activists Paying Bonuses to Directors*, WALL ST. J. (Jan. 17, 2014), http://tinyurl.com/WSJ-Laud-1633.

[221]Mark P. Cussen, *Introduction To Phantom Stock And SARs*, INVESTOPEDIA, http://tinyurl.com/IOP-70CE (last visited Oct. 15, 2016).

[222]*Id.*

[223]*E.g.* Callaway Golf Co., Current Report (Form 8-K) (Dec. 30, 2009) *archived at* http://tinyurl.com/SEC-1640. Exhibit 10.57 details the terms of the executive phantom stock plan. The terms are typical of the incentive performance plans offered by many companies.

[224]*See* Cussen, *supra* note 221.

[225]*Id.*

date at $10. At the date of payment, the employee would receive $100 under a "full value" plan and $60 under an "appreciation only" plan.

In a bonus bank concept as applied to a company, a part of the director's annual bonus will be paid out to him and the rest will be deposited into an account.[226] The money can be drawn down over the next couple of years, *e.g.*, three years, provided the company meets or exceeds predetermined operating targets and other benchmarks. If not, "the [director] stands to lose some or all of the funds in the account."[227] This strategy definitely discourages the directors from ensuring results one year at the expense of the next; until the complete payout of their bonus payments, the directors will retain the incentive to continue to perform and ensure better outcome for the company.[228] Also, bonus plans should not be mere caps, for the director loses the incentive to continue performing once such caps are attained. Instead, they should at linear or non-linear intervals define different levels at which bonus earned will be increased.[229]

D. *Changing Company Bylaws and Policies*

As discussed in Section VII of this article, variance in director compensation structure was alleged to lead to board balkanization and ultimately a failure in collective decision-making.[230] Moreover, the existence of a legislative void to adequately address the independence of board members *vis-à-vis* shareholders has cast doubts on the credibility of dissident directors.[231] There exists another aspect, closely linked to board independence, which has not been advocated as much by the challengers of nominee compensation, but is nevertheless very pertinent and can be addressed with joint efforts of the nominating activists and the corporation. In the *Kalisman* Decision, the Delaware Court of Chancery addressed whether a dissident director, Mr. Kalisman, could be precluded from attending company board meetings and accessing the company's confidential information, because the rest of the board feared him conveying material company information to his nominating

[226]Gerry Hansell et al., *Fixing What's Wrong with Executive Compensation*, BOSTON CONSULTING GROUP, at 7, (June 2009) *archived at* http://tinyurl.com/BCG-1567.

[227]Nanette Byrnes, *Executive Pay: Bonus Banks*, BLOOMBERG BUSINESS (Feb. 4, 2009), http://tinyurl.com/BB-Kent-1037.

[228]*Id.*

[229]*See generally* George P. Baker, ET AL., *Compensation and Incentives: Practice vs. Theory*, 43 J. OF FIN. 593, 593-616 (1988).

[230]*See supra* Part VII.

[231]*See supra* note 178-79 and accompanying text.

shareholder.[232] The court in this case, held that a director's right to company information is "essentially unfettered in nature," and the company may not pick and choose which directors receive which information.[233] The court held that "Kalisman should be treated as a 'joint client' in respect of legal advice rendered to the company, insofar as he, like the other directors, had a responsibility for proper management of the company."[234] What is interesting in this case is that the court has also noted that a corporation could adopt limitations on the rights of dissident directors, as long as it has established a record of open and informed deliberation that facilitates the ability of all directors to fulfill their fiduciary duties.[235] While the corporation and its managerial labor might not appreciate having a dissident nominee (whether or not conflicted) on board decision-making, instead of uninformed and outright preclusion of such director, they would need to find a way to balance the hedgehog's dilemma. The court in the *Kalisman* Decision suggested creating a special committee dealing with the negotiation of a specific transaction, which could exclude certain directors with their knowledge and consent and that such a committee could retain separate legal counsel for this purpose.[236] Thus, the ruling indicates that courts will not hestitate to interefere and scrutinize those actions of a corporation, which either impede voting rights of a dissident director or are otherwise not in accordance with good governnace practices.[237]

In addition to the above, the company could formulate bylaws, which require all dissident nominee directors, prior to accepting to be a nominee, to give an undertaking in writing to adhere to all the company policies, including the manner of treating and using confidential information. Pursuant to such a bylaw, they could also be asked to explicitly agree in writing that they would not act as a representative or in the interest of any particular sharheolder or group of shareholders while performing their duties as company directors. The company could also adopt a specific policy or amend its existing policy pertainting to confidentiality obligations of its directors and employees, to specifically provide for a prohibition of disclosure of such information to shareholders or third parties.

---

[232] Kalisman v. Friedman, 2013 WL 1668205, at *2 (Del Ch. Apr. 17, 2013).

[233] *Id.*

[234] Martin Lipton et al., *Wachtell Lipton Discusses Delaware Court of Chancery Guidance for Dealing with Dissident Directors*, CLS BLUESKY BLOG (July 3, 2013), http://tinyurl.com/CLS-1644.

[235] *Kalisman*, 2013 WL 1668205, at *4-5.

[236] *Id.*

[237] *Id.*

It is true that the duty to keep company information confidential is very much a subset of the fiduciary duties of directors under state common law; embedding such restrictions in company bylaws, policies or as sepaprate arrangements with such nominee directors, imposes additional contractual obligations on such directors.[238] Moreover, internal disciplinary procedures would enable expedited resolution of any violation of such contractual obligations, as against having to go through the court driven process to prove breach of common law principles. The bylaw could also prescribe the repurcussions of a possible violation of such requirements—such director could be asked to submit a resignation upfront and/or his directorship could be suspended, until it is judicially decided that the director intentionally disclosed confidential company information to a third party in breach of his confidentiality obligations to the company under any policy or aggrement applicable to the director. Additionally, the company could also make him liable for huge monetary damages; possibly clawback a percentage of his past payments and also suspend any future payments that he may be entitled to otherwise.

However, while trying to incorporate checks on the director nomination process, it is important for the company to tread carefully, and have a rational basis for any limitations imposed on shareholders or their nominee directors. [239] As discussed in Section III of this article, an overly intrusive bylaw or amendment to an exisiting policy (like the Wachtell Disqualifying Bylaw) opens up the possibility of being challenged for impeding the effective exercise of the shareholder franchise and hence in violation of the *Blasius* Standard.

E. *Reinforcing Disclosure Requirements*

Though the current SEC requirements require the disclosure of compensation of directors, along with a narrative of the material factors necessary to understand the same, they might not mandate disclosure of adequate information regarding compensation to be paid to a board nominee by a nominating shareholder if the nominee is elected to a company's board.[240] The cash retainer awarded to the nominee for his candidacy on the board as well as future conditional payments might not get covered under the existing requirements.

---

[238] *Hedgehog's Dilemma*, WIKIPEDIA (2016), http://tinyurl.com/Dunbar-1650.

[239] Peter Atkins, *Rethinking Director Nomination Requirements and Conduct*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (July 17, 2013), http://tinyurl.com/gwq5wg8.

[240] Letter from Jeff Mahoney, CII to Keith Higgins, US SEC, *Compensation Arrangements Between Nominating Shareholders and Board Nominees* (Mar. 31, 2014), *available at*, http://tinyurl.com/hnburz9.

If activist shareholders are agreeable to provide complete disclosure of the compensation arrangements of their nominee candidates *before* conducting director elections, it would give visibility to the shareholders of the company of the nature and extent of remuneration offered to these candidates by such third parties. So long as such compensation arrangements are disclosed *prior* to board member election, it is difficult to understand how they could be regarded more perilous than setting and awarding obscenely high and varied compensation amongst board members by the compensation committee *after* their election.

Amongst others, the Council of Institutional Investors (CII) has written to the SEC specifically requesting them to ensure that investors are provided with information that will enable them to make informed voting decisions.[241] The proxy contest documents should not only disclose the existence of such compensation arrnagements between the nominating shareholder and the nominee director, but also the various components of such compensation, objectives that they seek to achieve, indemnification, and conflicts of interest. Canada's securities regulation that requires the disclosure of 'any arrangement or understanding' between the proposed director and any other person, has been interpreted to include such special compensation arrangements.[242]

As an extension of the argument made in Section III of this article—if shareholders are considered matured and capable to engage in proxy contests, they should also be permitted to determine if the compensation promised to dissident nominees affects their candidature. Shareholders can be expected to make a responsible decision, only with complete disclosure of such compensation arrangements in the proxy statements. Thus, in order to ensure that the democratic process of electing directors on the board of the corporation is carried out efficiently, there is an urgent need to beef up the law requiring such disclosures. And until the SEC makes such amendments to the extant requirements, companies could choose to enact bylaws, with the apporval of not only the board but also the shareholders, incorporating such mandatory disclosures to ensure fairness in director elections.

IX. CONCLUSION

A 360 degree analysis of the adverse reactions of corporations and their management, to dissident director compensation by activist hedge funds, makes it abundantly clear that the latter's reputation of not-being

[241] *Id.*
[242] Iacobucci, *supra* note 158.

considered invested for a long enough duration in the corporation, is the root cause of all objections. These assertions of an inherent conflict of interest between the nominee's duties to the corporation and to the nominating investor are made on the assumption that while the corporation might require the nominee to manage the company for the long term, the activist investor might require them to manage his favorable exit from the company. This is the basis on which antagonists of hedge funds and their practice of nominating and compensating nominee directors, propagate that a long-term rule would ensure that directors act pursuant to their fiduciary duties in maximizing stockholder value, and not in the interests of the activists.[243] Notwithstanding the merits of these assertions, it cannot be disputed that every investor makes an investment with an investment horizon; there is no permanent investor in a company.[244] As previously assumed five years to be the tentative 'long-term' duration in Section VIII of this article, it is highly unlikely that the large shareholders of a typical US corporation qualify as long-term investors; often they pursue their investment interests, which could require them to sell down or exit the corporation before the expiration of five years.[245] Though litigated on several occasions, the Delaware courts have never endorsed this view. Instead, in *Paramount v. Time*, the Delaware Supreme Court has clearly held that Delaware corporate law obliges all directors to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon and that the question of 'long term' versus 'short term' value is largely irrelevant.[246] With this case, the court has not only rejected the idea that directors must choose the long-term as the exclusive time frame for maximizing stockholder value, but also the fact that it is unwise to place undue emphasis upon long-term versus short-term corporate strategy.[247]

This is essentially yet another paradigm of the hedgehog's dilemma faced by the company and its management, with the existence of hedge fund compensated directors on the company's board, responsible for managing its business and affairs. In the absence of a

---

[243] Jack Bodner, Leonard Chazen, & Donald Ross, *Vice Chancellor Laster and the Long-Term Rule*, HLS FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Mar. 11, 2015), http://tinyurl.com/HLS-11iii15; *In Re* Rural/Metro Corporation S'holders Litig., 102 A.3d 205, 253 (Del. Ch. 2014).

[244] *See* Maik Dierkes, Carsten Erner, & Stefan Zeisberger, *Investment horizon and the Attractiveness of Investment Strategies: A Behavioral Approach*, 34 J. OF BANKING AND FIN., 1032 (2010) (discussing various types of investment horizons).

[245] *See generally* Robert C. Pozen, *Curbing Short-Termism in Corporate America: Focus on Executive Compensation,* GOVERNANCE STUDIES AT BROOKINGS (May 2014) http://tinyurl.com/jetnvns (discussing institutional investors and short-termism).

[246] Paramount Communications Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989).

[247] Bodner, *supra* note 243.

regulation making this practice illegal, the company and its management are also required to act within the realms of the law of the land. Outlawing hedge fund activists from compensating their director nominees by a unilateral adoption of bylaws that disqualify such third-party compensated directorial candidates, only signals a desperate attempt of the management to clip the wings of activist hedge funds, in fear of their influence on board decision-making. Anxieties pertaining to director independence, confidentiality of corporate information and the possibility of the special compensation packages creating perverse incentives for dissident nominee directors should be tackled with making amends to the company's bylaws, requiring more elaborate disclosures of compensation arrangements and most importantly, fine-tuning the compensation structures to ensure a more dedicated board.

***