SERVANTS OF TWO MASTERS? THE FEIGNED HYSTERIA OVER ACTIVIST-PAID DIRECTORS

Yaron Nili*

Directors of U.S. public firms have historically been paid for their directorship exclusively by the company in which they serve. Recently, however, activist investors have asked shareholders to elect director-candidates who received a lucrative compensation package from the activist in addition to their compensation arrangement with the company. Incumbent managers and their defenders, such as Wachtell, have sharply condemned this practice, terming it a 'golden leash' that subjects the nominated director to the activist's control. In this Article, I explain why these critics are mistaken. Activist-paid directors can be expected to improve corporate performance at poorly performing firms, and the cost of such arrangements, if any, is likely to be much lower than that of similar arrangements that are already widely used throughout corporate America and are welcomed by these critics.

* Fellow of the Program on Corporate Governance, Harvard Law School, and Co-Editor of the Harvard Law School Forum on Corporate Governance and Financial Regulation. I would like to thank Lucian Bebchuk, Jesse Fried, Scott Hirst, Kobi Kastiel, Charlie Penner, Mark Roe, Ed Rock, Roy Shapira, the participants at the 2015 ALEA Annual meetings, the participants at the Law and Economics seminar at Harvard Law School, and the participants at the Corporate Governance Fellows group for helpful conversations and comments. I am grateful for financial support from the Program on Corporate Governance at Harvard Law School.

INTRODUCTION: THE FEIGNED HYSTERIA AROUND ACTIVIST-PAID DIRECTORS

Director compensation in the U.S. could be perceived as a relatively mundane and uneventful topic. Directors are most often elected without challenge, based on the company's recommendation. They serve, at least in theory, all shareholders and owe their duties to the corporation. They most often control their own tenure, deciding when to retire. In each company, directors are compensated equally regardless of their affiliation, credentials or tenure.[1] This parity has been lauded as a crucial element in promoting board 'cohesiveness' and teamwork to the benefit of all shareholders.

Now, imagine a world in which directors receive compensation for their work not only from the company in which they serve, but also from other interested parties. Imagine a world in which directors might not have such a tight grip on their seats. Imagine a world where an activist hedge fund, whose motives are not clear, entices candidates for board positions by offering them large sums of cash or equity, potentially up to an additional $1 million over a few years, if they fulfill certain thresholds that are set up by the hedge fund and not by the company or the general shareholder base. Imagine a world in which several nominees of a hedge fund gain seats on the board of a target company, having these side-payment deals in place, with the activist that nominated them to the position. Imagine a board that is fragmented, and may hold loyalty to multiple masters.

What would you think of that world? Should we allow for differentiation between board members' compensation? Are we comfortable with allowing specific shareholders to set goals for some board members without the intermediation of the company or the shareholder base as a whole? Your gut reaction might be: there is something wrong with such a world. It just doesn't feel right to have directors hold loyalty and interests to both the company and a specific shareholder. You might be concerned that fractioning the board would entail too high of a cost.

1. With some slight differentiation based on specific committee service and the position of chairman, see *infra* note 82 and accompanying text.

Let's just leave things be, you would advocate. Mundane is good, you could argue.

Well, this imaginary world is not imaginary any longer. Over the past six years there have been several attempts by hedge fund activists to nominate candidates that had agreements for side-payments with the activist fund. In November 2014, these attempts finally culminated in a first case of appointment, through negotiated agreement, of board members who were nominated by an activist hedge fund and who are paid, in addition to their board compensation, with up to four payments of $250,000 based on the company and the activist success.

The emergence of activist-paid nominees was met with strong reactions. Companies and their lawyers raised concerns regarding the independence of the nominees, coining the term 'golden leash' with respect to these compensation structures.[2] Concerns regarding board cohesiveness, motivation and loyalty of these directors mounted[3] and some prominent academics were very critical of these arrangements, commenting that, "[i]f this nonsense is not illegal, it ought to be[,]"[4] that "third-party bonuses create the wrong incentives, fragment the board and imply a shift toward both the short-term and higher risk[,]" and that the "end does not justify the means."[5]

But is this new, non-imaginary world really so concerning? Should it be? Is the hysteria over these payments truly justified? This Article strives

2. *See* Janet Mcfarland, *Jana's Agrium Pay Scheme Draws Fire*, THE GLOBE AND MAIL (Toronto), (Mar. 04, 2013), http://www.theglobeandmail.com/globe-investor/janas-agrium-pay-scheme-draws-fire/article9256064/ [perma.cc/3CPE-CD4N] ("'This kind of 'golden leash' arrangement is unheard of in Canada and raises serious questions about the independence of Jana's nominees and their ability to act in the best interests of all shareholders,' Mr. Zaleschuk said in a letter to Agrium shareholders. . . .").

3. *See* David Benoit, *Bank Directors Get Nod Amid Criticism on Pay Stance*, WALL ST. J., Nov. 29, 2013, at C3, http://online.wsj.com/news/articles/SB10001424052702304017204579224200100433792 [perma.cc/5Q8A-UJTW] (revealing widespread criticism of Provident directors because of their support for bylaw amendments that would bar nominees from getting paid by activist investors who support them).

4. Stephen M. Bainbridge, *Can Corporate Directors Take Third Party Pay From Hedge Funds?* (Apr. 08, 2013, 09:51 PM), http://www.professorbainbridge.com/professorbainbridgecom/2013/04/can-corporate-directors-take-third-party-pay-from-hedge-funds.html [perma.cc/C7YQ-9FEP].

5. John C. Coffee, Jr., *Shareholder Activism and Ethics: Are Shareholder Bonuses Incentives or Bribes?* THE CLS BLUE SKY BLOG (Apr. 29, 2013), http://clsbluesky.law.columbia.edu/2013/04/29/shareholder-activism-and-ethics-are-shareholder-bonuses-incentives-or-bribes/ [perma.cc/F22T-RJ7Z]; *see also* Martin Lipton, *ISS Addresses Dissident Director Compensation Bylaw*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 21, 2013), http://blogs.law.harvard.edu/corpgov/2013/11/21/iss-addresses-dissident-director-compensation-bylaw/ [perma.cc/P652-YNAD] (noting a recent ISS recommendation that shareholders of small cap bank withhold their votes from director candidates).

to debunk some of the underlying assumptions that fuel this hysteria over third-party compensation arrangements to directors and by taking a more nuanced, case based approach to the topic by suggesting several demarcating lines that could prove useful in examining each of the specific compensation arrangements in question.

Specifically, this Article argues that the aforementioned mundane world of the board never really existed—that directors have always been appointed by and held allegiance to third parties and interested shareholders, even before this latest surge in activism; and that directors' interests and equity stakes in the company inherently vary, with or without activist presence. As such, the world of a united, cohesive board, a board that earns the same pay and is comprised of appointees of the company as a whole, never truly or fully existed. Against this more accurate portrait of the world, the outcry of companies and academics against the introduction of activist-paid nominees fails to acknowledge the already embedded complexity of boards' financial and non-monetary interests, while simultaneously ignoring the significant potential benefits the introduction of activist-paid directors to corporate boards might entail.

This Article continues as follows: Part II details the backdrop against which supplemental pay to directors has emerged and provides more detailed information regarding this new pay structure and the objections to it. Part III provides important, but yet often overlooked, data regarding director pay. Part IV presents the benefits activist-paid directors might provide, both to the activist themselves and to shareholders as a whole. Part V responds to the main arguments against such pay practice while Part VI strives to provide some rudimentary bright-line guidelines that could help in building a framework that examines such pay practices on their merits, ad-hoc, and does not exclude them altogether. Part VII then concludes.

I. THE RISE OF SHAREHOLDER ACTIVISM AND THE CONTROVERSY OVER ACTIVIST-PAID DIRECTORS

A. *The Rise of Shareholder Activism*

1. The Origins of Shareholder Activism

Activist investors, hedge funds and private equity firms have been playing an increasingly important, and active, role in corporate America. Their participation, alongside other changes to the corporate landscape,[6]

6. Among the recent changes are the SEC proxy reform, the establishment of the say

has created a surge in the activism movement in the U.S.[7] Prior to the emergence of these new institutional investors, it was hoped that traditional institutional investors, such as pension funds and mutual funds, would act as shareholders' safeguards. In reality, however, their involvement was barely noticed. Most traditional institutions were limited in the amount of equity stake they could hold in a single corporation and in the composition of their financial compensation structure.[8] The traditional institutions suffered from conflicts of interest and political influence[9] that prevented or

on pay as part of the Dodd-Frank Act, the regulation of some private funds, etc. For a review of these changes, *see, e.g.*, Tod Perry & Randle B. Pollard, *"Grade Incomplete": Examining the Securities and Exchange Commission's Attempt to Implement Credit Rating and Certain Corporate Governance Reforms of Dodd-Frank*, 41 U. IND. L. REV. 147, 157 (2014) (discussing the changes made by the SEC to proxy access, Say on Pay, and several other regulations as a result of the Dodd-Frank Act); Lucian A. Bebchuk & Michael S. Weisbach, *The State of Corporate Governance Research*, *in* CORP. GOVERNANCE 325, 329 (Boubaker et al. eds., Springer 2012) (highlighting the debate regarding whether increasing shareholder activism is part of the problem or the solution); Aviv Pichhadze, *Is the SEC A Learning Regulator? Lessons From Proxy Access*, REG. & GOVERNANCE 1, 3 (2013) (suggesting an increase of layering - regulatory systems characterized by competing logics, thereby creating inherent tensions - in the post-Crisis U.S.).

7. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 688–89 (2007) (discussing impediments to replacing boards even when shareholder dissatisfaction is high); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1024 (2007) (noting how hedge fund have become critical players in corporate governance and control); Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1087 (June 2015) (highlighting the recent increase in shareholder activism, creating a debate as to whether such activism is more beneficial or harmful).

8. The fee structure used by traditional institutions has a direct influence on their activism as it is correlated with their size, not with their performance. New institutions use an incentivized fee structure, commonly called 2/20, which gives them 20% of the portfolio upside (without sharing the downside) and a 2% management fee, which induces them to invest funds in improving governance. *See, e.g.*, John C. Coffee, *The SEC and The Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 903 (1994) (discussing the differences between traditional funds' incentive fee structures and newer venture capitalist, private equity, and hedge fund incentive fee structures); Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, *in* THE NEW PALGRAVE DICTIONARY OF ECON. AND L. 459 (Peter Newman ed., 1998) (generally defining the state of shareholder activism in the U.S.).

9. *See* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 799-831 (1993) (explaining the conflict of interest public pension funds face as investors, balancing political pressure and the interests of fund beneficiaries); *see also* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 570-75 (1990) (noting the rise of shareholder activism); Diane Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, 52 J. FIN. ECON. 293, 294 (1999) (discussing the argument whether political pressure on public pension funds motivates activism, and that such pressure conflicts with the interests of fund beneficiaries); Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275, 279-80 (2000)

decreased their level of activism,[10] and these factors reduced their incentives to invest in improving governance.[11]

Hedge funds and private equity funds, on the other hand, are free from these regulatory limitations:[12] they are not limited in the amount of equity they can acquire in one corporation; they have incentive-based fee structures;[13] and they are not bound by political or business constraints.[14] The fee structure of hedge funds and other less regulated financial institutions, coupled with their tendency to magnify their equity stake by using sophisticated derivatives,[15] has induced some of them to take an active role in the governance of U.S. public firms. Most often, these funds get involved through a public call for change, request for board representation, threatening their portfolio companies with a proxy fight, and sometimes launching one.[16] In their efforts to exert influence, hedge funds have also used legal remedies, such as requests for injunctions against management proposals and for public declarations of intentions.[17]

(investigating the role of activist institutional investors, which arose due to the conflict of interest between management and shareholders); Jonathan M. Karpoff et al., *Corporate Governance and Shareholder Initiatives: Empirical Evidence*, 42 J. FIN. ECON. 365, 366 (1996) (discussing the role of activist institutional investors to pressure management and align management's incentives with those of shareholders).

10. *See* Kahan & Rock, *supra* note 7, at 1048 (exploring factors that decrease activism).

11. Direct regulation and tax regulation prevented institutions from holding large stakes in a single corporation. *See* Mark Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 17-30 (1991) (discussing the effects of regulations on various institutions' ability to invest).

12. For an explanation of why hedge funds are not subject to the Investment Company Act of 1940, see William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1382 n.33 (2006). For information about the various types of hedge fund investment strategies, see René Stulz, *Hedge Funds: Past, Present and Future*, 21 J. OF ECON. PERSP. 175, 182 (2007). For a discussion of the current state of limited private equity regulations, see Brian Cheffins & John Armour, *Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 55-59 (2008).

13. *See supra* notes 7 and 8 and accompanying text (describing the fee structure of funds as based on size, not performance).

14. *See supra* note 12 (describing why funds operate with little regulation).

15. Hedge funds tend to use the derivatives market much more commonly and aggressively than other institutions. Thus, a hedge fund can increase its equity interest in a corporation just by buying derivative assets (as put or call options), thereby amplifying its economic interest without needing to increase its actual shareholdings in the firm. *See* Kahan & Rock, *supra* note 7, at 1062 (noting that 15% of hedge funds use leverage at a ratio in excess of two and that 35% to 55% use leverage at lower ratios).

16. *See* Bratton, *supra* note 12, at 1402-03 (explaining how hedge funds pursue activist agendas against target companies).

17. See the legal challenge against Apple's attempt to bundle several topics under one management resolution and the motive of the activist hedge fund to force a public discussion over the payout policy of the company. While the suit was aimed at Apple's

And while the traditional institutional investors have failed to lead the way, the increasing involvement of these new institutions and the emergence of proxy advisory firms have also stimulated the activism conducted by the traditional institutions, leading to an overall increase in the number of shareholders willing to take an active role in the governance of the corporation.[18]

This surge in activism, coupled with the attention it merits, has propelled activism from a localized occurrence into a matter that dominates both the business arena and corporate governance scholarly discourse. Indeed, activist investors have been lauding this new landscape, with Carl Icahn, one of the most prominent and long-tenured activist investors, stating that "there has never been a better time . . . for activist investing."[19] Similar sentiments can be found in the statement by Mark Mobius, the executive chairman of Templeton Emerging Markets Group that "shareholder activism is not a privilege–it is a right and a responsibility. . . . If we believe there is something going wrong with the company, then we, as shareholders, must become active and vocal."[20]

bundling of several matters under one management proposal, the underlying motive involved Apple's overall dividend policy and the large amount of cash Apple was hoarding. *See* Jennifer Ablan & Poomima Gupta, *Einhorn Sues Apple, Marks Biggest Investor Challenge in Years*, REUTERS (Feb. 7, 2013, 10:42 PM), http://www.reuters.com/article/us-apple-greenlight-idUSBRE9160MI20130208 [perma.cc/8MGZ-RKP3] (discussing an activist suit against Apple to issue preferred stock with increased dividend payments); *see also* William Alden, *Einhorn's Apple Suit Fits a History of Public Calls*, N.Y. TIMES DEALBOOK (Feb. 7, 2013, 4:36 PM), http://dealbook.nytimes.com/2013/02/07/taking-on-apple-einhorn-has-a-history-of-public-calls/ [perma.cc/C848-8KT7](discussing several of the suits activist investor David Einhorn has pursued against different companies).

18. *See* Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315 (2008) (documenting the developing role of public pension funds in corporate governance); David Gelles & Michael J. de la Merced, *New Alliances in Battle for Corporate Control*, N.Y. TIMES DEALBOOK (Mar. 18, 2014, 9:40 PM), http://dealbook.nytimes.com/2014/03/18/new-alliances-in-battle-for-corporate-control/?_php=true&_type=blogs&_r=0 [perma.cc/2AM3-6JA9] (describing the shift in the struggle for corporate control toward activist investors); Matteo Tonello, *Global Trends in Board-Shareholder Engagement*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Oct. 25, 2013), http://blogs.law.harvard.edu/corpgov/2013/10/25/global-trends-in-board-shareholder-engagement/ [perma.cc/R4RK-D6FT] (summarizing the current state of increased shareholder engagement and advocating for directors' response to shareholder concerns).

19. Sam Forgione, *Carl Icahn Says No Better Time to Be an Activist Investor*, REUTERS (Nov. 4, 2013, 5:58 PM), http://www.reuters.com/article/2013/11/04/us-icahnenterprises-results-idUSBRE9A312F20131104 [perma.cc/LD7S-4YY3] (quoting the 2013 third quarter report of Carl Ichan's activist investment vehicle, Ichan Enterprises L.P.).

20. Mark Mobius, *Knowing Your Shareholder Rights*, INVESTMENT ADVENTURES IN EMERGING MARKETS (Apr. 2, 2010), http://mobius.blog.franklintempleton.com/2010/04/02/knowing-your-shareholder-rights/

This golden age of activism is reflected not only in the amount and success rates of activist campaigns,[21] or in the sentiment of activist investors themselves. The SEC chair, Mary Jo White, has touted the benefits of shareholder activism[22] joining a vast literature that has been supporting the shareholder franchise and calling for more shareholder involvement in corporate life.[23] In turn, companies, practitioners and others have raised concerns regarding the benefits of activism and the intentions of shareholders, leading to a highly charged debate on the merits of increased shareholder activism in the governance of widely held corporations.[24]

[perma.cc/3SVG-LXB4] (detailing an example of successful minority shareholder activism with a large international manufacturing company).

21. *See infra* note 101 and accompanying text (describing the rise in success rates of proxy fights); *see also Contested U.S. Elections, Mergers in 2013*, ISS GOVERNANCE WEEKLY (Sept. 13, 2013) (stating that the resurgence of contested board elections, which began in 2012, continued into the 2013 proxy season); John J. Madden, *The Evolving Direction and Increasing Influence of Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 23, 2013), http://blogs.law.harvard .edu/corpgov/2013/12/23/the-evolving-direction-and-increasing-influence-of-shareholder-activism/ [perma.cc/E5CK-PK9U] ("According to ISS, . . . [p]roxy contests to replace some or all incumbent directors went from 9 in the first half of 2009 to 19 in the first half of 2012 and 24 in the first half of 2013. And the dissident win rate has increased significantly, from 43% in 2012 to 70% in 2013. . . . [D]ata from Sharkrepellent for 2013 through mid-September shows similar dissident success. For that period, Sharkrepellent reports 37 contests filed and 23 going to a shareholder vote; with a dissident win rate of 65%."); SharkRepellent.net, *The Proxy Fight for Board Seats Trend Analysis Report*, (Sept. 17, 2013) (on file with author) (listing proxy fights from January 2013 to May 2013).

22. *See* Sarah N. Lynch, *SEC Chair White Touts Benefits of Shareholder Activism*, REUTERS (Dec. 3, 2013), http://www.reuters.com/article/2013/12/03/us-sec-shareholder-activism-idUSBRE9B20TC20131203 [perma.cc/9P5S-VWBA] (reporting on SEC Chair Mary Jo White's speech at a conference organized by the European Corporate Governance Institute on the use of shareholder activism as a tool to foster communication between management, boards, and shareholders).

23. The main proponent of this movement is Professor Bebchuk. *See, e.g.*, Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 835, 836 (2005) (analyzing empirical evidence to suggest an alternative regime of increased shareholder power to improve corporate governance arrangements); Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1784-85 (2006) (arguing that shareholder power, even with its shortcomings, would improve corporate governance arrangements); Bebchuck, *supra* note 7, at 676 (arguing that current shareholder powers are insufficient to make boards accountable).

24. *See, e.g.*, Bebchuk et al., *supra* note 7, at 1089 (conducting a systematic empirical investigation to refute myopic-activists claims); *see also* Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 734 (2007) (criticizing Bebchuk's calls for shareholder reform as radical, shifting power to shareholders at the expense of managers and directors). One of the main concerns is about the use of activism for short-term self-interest over the long-term efficiency of the firm. This is balanced against the risk of potentially leading to over-activism that will distort daily life at the firm and harm the

2. The Beneficial Effects of Shareholder Activism

While early academic writing has focused on the general theoretical benefits of shareholder involvement in corporate affairs,[25] recent studies have provided more concrete evidence regarding the benefits of activism. Numerous studies in the last few years have demonstrated that activists are adding value to their target corporations via multiple channels and that such value creation, despite some critics' contentions, is not only in short-term but that it is sustained for the long-term.[26] Indeed, studies have found activists to be adding value to target companies by engaging in tax planning and structure;[27] improving corporate governance;[28] reducing

board and management's ability to steer the corporation effectively. *See, e.g.*, LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC, 63–73 (2012) (summarizing the divergence of interest between long-term and short-term investors); Stephen M. Bainbridge, *Responses: Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1744–51 (2006) (explaining why limited shareholder voting rights is the default in corporate law); William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 653–54, 657–59 (2010) (countering the argument that shareholder empowerment will reduce management agency costs); Justin Fox & Jay W. Lorsch, *What Good Are Shareholders?*, HARV. BUS. REV., July–Aug. 2012, at 49, 51 (discussing problems created by increase in shareholder power and rise of short-term investors). Similar concerns were raised regarding hedge funds' use of derivatives to manipulate other shareholders. *See, e.g.*, Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815-16 (2006) (expressing concern that the rise of hedge funds and shareholder activism will encourage the separation of voting rights and ownership of shares); Marcel Kahan & Edward B. Rock, *supra* note 7, at 1070-72 (discussing concerns related to hedge fund activism). Recent research has cast some doubt on the empirical validity of these concerns. *See, e.g.*, Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1667 (2013) [hereinafter Bebchuk 2013] (noting the lack of empirical support of insulation advocates' claim that activist interventions lead to long term losses); Lucian A. Bebchuk et al., *supra* note 7, at 1101-35 (providing empirical evidence regarding the positive effects hedge funds have on firm performance in the long term); Mark J. Roe, *Corporate Short-Termism – In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 1005 (2013) (concluding from a system-wide analysis that further judicial isolation of boards from markets is untenable); and Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders* Forthcoming, 124 YALE L.J. 1554, 1557 (2015) (questioning the benefit of giving long-term shareholders more power over public companies).

25. *See, e.g.*, Bebchuk, *supra* note 7, at 679 (arguing in theory that the power to run a company is vested in the board of directors as an agent of shareholders, and not in management).

26. *See* Bebchuk 2013, *supra* note 24, at 1663 (arguing that activists have incentives to seek actions with both short-term and long-term payoffs).

27. *See* C. S. Agnes Cheng et al., *The Effect of Hedge Fund Activism on Corporate Tax Avoidance*, 87 ACCT. REV. 1493, 1495 (2012) (observing that businesses exhibit lower tax avoidance levels prior to hedge fund activism, but higher levels post-intervention).

28. *See* Vicente Cuñat et al., *The Vote Is Cast: The Effect of Corporate Governance on*

managerial entrenchment and shareholder passivity;[29] increasing short-term returns and long term value creation in share value; introducing operational, financial, and governance improvements to enhance corporate efficiency;[30] and properly allocating resources to corporate innovation[31] and CEO pay.[32]

Importantly, these benefits have positive spillover effects. While activist intervention is at times necessary, the mere threat of activist intervention can induce managers of other public companies to take steps to generate value for shareholders in order to prevent activists from targeting their companies in the first place.[33] Thus, the increased credibility of the

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Shareholder Value, 67 J. FIN. 1943, 1944 (2012) (providing a causal estimate that passing a governance proposal increases shareholder value).

29. *See* Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1910 (2013) (arguing that shareholder concentration and activism, among other things, shifted the U.S. system from manager-centric system to a shareholder-centric system); *see also*, Marcel Kahan & Edward Rock, *Symbolic Corporate Governance Politics*, 94 B.U. L. REV. 1997, 1998 (2014) (arguing that corporate governance politics are more symbolic than reflective of reality).

30. *See* Bebchuk 2013, *supra* note 24, at 1663 (discussing positive long-term payoffs activists could bring such as replacing an incompetent CEO); Marco Becht, et al. *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund*, 23 REV. FIN. STUD. 3093, 3097 (2010) (reporting the success of the Hermes UK Focus Fund's unique form of activism in generating returns for its investors); Alon Brav et al., *The Real Effects of Hedge Fund Activism: Productivity, Risk, and Product Market Competition* (U.S. Census Bureau: Ctr. for Econ. Stud. Paper, Nov. 17, 2011) at 2 (finding that companies in competitive industries experience an improvement in production efficiency after hedge fund activism); Shane Goodwin, *Myopic Investor Myth Debunked: The Long-Term Efficacy of Hedge Fund Activism in the Boardroom*, (June 13, 2014) (unpublished manuscript), at 7, *available at* http://ssrn.com/abstract=2450214 [perma.cc/4NRF-M4MQ] (finding that hedge funds generate long-term value for shareholders of target firms).

31. *See* Alon Brav et al., *Shareholder Power and Corporate Innovation: Evidence from Hedge Fund Activism* (Kelly Sch. of Bus., Research Paper No. 2014-05, 2014), at 3-4, *available at* http://ssrn.com/abstract=2409404 [perma.cc/6GZN-KAXU] (finding an improvement in innovation efficiency for firms targeted by hedge funds); Zhongzhi He et al., *Hedge Fund Activism and Corporate Innovation* (Mar. 19, 2014) (unpublished manuscript), at 31-32, *available at* http://ssrn.com/abstract=2411739 [perma.cc/V9YD-C8MA] (finding that both innovative and non-innovative firms have the same likelihood of being targeted by activist hedge funds, which subsequently enhance innovative activities).

32. *See* Yonca Ertimur et al., *Shareholder Activism and CEO Pay*, 24 REV. FIN. STUD. 535, 576 (2010) (finding empirical evidence supporting an advisory "say on pay" vote).

33. For literature discussing the ex-ante benefits of activism, see, for example, Heqing Zhu, *The Preventive Effect of Hedge Fund Activism* (Nov. 1, 2013) (unpublished manuscript), at 6-8, *available at* http://ssrn.com/abstract=2369533 [perma.cc/ZE7T-4HGL] (examining the effectiveness of hedge fund activism in increasing shareholder distribution and decreasing CEO pay); Nickolay Gantchev et al., Governance under the Gun: Spillover Effects of Hedge Fund Activism (Jan. 13, 2015) (unpublished manuscript), at 2, *available at* http://ssrn.com/abstract=2356544 [perma.cc/BBN7-SE9Y] (investigating manager perception of activism as a threat and resulting policy changes); April Klein & Emanuel

option for activism, might serve as an effective disciplinary force, improving firm performance, even without actual activist involvement.

And indeed, activist campaigns have not only garnered attention but also generated many recent success stories. For example:

> Activist investors led to new management being brought in at Yahoo, whose share price has since doubled, and encouraged the departure of Steve Ballmer from Microsoft, whose share price is higher than at any time since the dotcom bubble burst. Mr[.] Icahn forced Apple to hand back to investors some of its $160 billion cash pile. Even Tim Cook, [Apple's CEO], now admits that the firm does not have enough decent investment opportunities to absorb it.[34]

Similar successful campaigns were conducted by the Clinton Group winning a majority of seats on the board of Stillwater Mining,[35] Starboard

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Zur, *The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders*, 24 REV. FIN. STUD. 1735, 1735-37 (2011) (finding that hedge fund activism reduces bondholders' wealth); Bebchuk et al., *supra* note 7, at 1103-06 (providing empirical evidence regarding the positive effects hedge funds have on firm performance in the long term); Hadiye Aslan & Praveen Kumar, *The Product Market Effects of Shareholder Activism*, 2014 J. FIN. ECON. (forthcoming 2015), at 3-5, https://editorialexpress.com/cgi-bin/conference/download.cgi?paper_id=311&db_name=AFA2015 [perma.cc/HQS7-3LV5] (finding that activism grows target firms' market shares and improves price-cost markups); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. LAW 681, 723 (2007) (finding that hedge funds are pressuring managements to develop better practices); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 324 (2008) (examining hedge funds' organizational structures and finding that activism results in positive wealth creation in target firms).

34. *Corporate Upgraders*, ECONOMIST, Feb. 15, 2014, at 10. *See also* Nathan Vardi, *ValueAct Hedge Fund's Huge Microsoft Victory*, FORBES (Sept. 3, 2013, 9:00 AM), http://www.forbes.com/sites/nathanvardi/2013/09/03/valueact-hedge-funds-huge-microsoft-victory/ [perma.cc/WTZ5-EADQ] (illustrating the growing power of activist investors through ValueAct's gaining a seat on Microsoft's board with only a 0.8% stake); Sruthi Ramakrishnan & Edwin Chan, *Apple's New Finance Steward Maestri Takes Over $160 Billion Cash Haul*, REUTERS (Mar. 5, 2014, 10:20 AM), http://www.reuters.com/article/2014/03/04/us-apple-cfo-idUSBREA2315T20140304 [perma.cc/UB76-MBXH] (describing Apple's $160 billion free cash problem); Michael J. de la Merced, *Icahn Ends Call for Apple Stock Buyback*, N.Y. TIMES DEALBOOK (Feb. 10, 2014, 10:19 AM), http://dealbook.nytimes.com/2014/02/10/icahn-backs-off-apple-buyback-proposal/ [perma.cc/XR82-LGQD] (reporting Apple's repurchases of shares in spite of Carl Icahn's withdrawal of his proposal); Daisuke Wakabayashi, *Apple Ramps up Stock Buybacks*, WALL ST. J., Feb. 7, 2014, at B1, http://online.wsj.com/news/articles/SB10001424052702303496804579367543198542118 [perma.cc/8H4N-QF6G] (reporting Carl Icahn's proposal for Apple to buy back an additional $50 billion of its own shares).

35. *See The Activist Investing Annual Review 2014*, ACTIVIST INSIGHT, 2014, at 17, http://www.srz.com/The_Activist_Investing_Annual_Review_2014/ [perma.cc/RG4Y-2SGF] [hereinafter Activist Investing Review] (reviewing the growth in importance of

Value LP successfully overseeing a merger of Office Depot with Office Max and winning board representation,[36] Elliott winning board seats at Emulex and striking a deal that secured a share repurchase program,[37] and Pershing Square Capital Management winning a proxy fight to turn around Canadian Pacific Railway.[38]

All of the above highlights not only why activism has taken center-stage in public, business, and academic discourse, but also the important, and positive, role that activism serves in improving corporate performance. This realization is especially important since, as furthered elaborated below, if activism is on balance positive, then as a policy matter it should be facilitated and not restricted.

B. *The Controversy*

1. The Importance of Board Representation as an Activist's Tool

While activists differ in their internal structure, focus, and turnaround goals, an important part of any activist playbook is getting one or more seats on a target company's board. While getting a 'seat at the table' does not allow an activist to necessarily control the board, as the activist may desire in some cases, it does provide enough 'voice' to make sure that the ideas and vision the activist has for the company get a fair hearing in the boardroom. Sometimes, the activists themselves get board seats; in other instances, they nominate an independent director who is not employed by the activist, usually an industry expert who has expertise and an interest in

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activist investors at Stillwater Mining Company, where activism resulted in winning four board seats and removal of both CEO and Chairman).

36. *See id*. at 14 (reporting Starboard Value's 2013 success in winning board representation after a merger between OfficeDepot and Office Max); *see also* Anupreeta Das et al., *Office-Gear Suppliers Discussing A Merger*, WALL ST. J., Feb. 19, 2013, at B1, http://online.wsj.com/news/articles/SB10001424127887323495104578312262231011572 [perma.cc/3XLZ-M69J] (reporting on the OfficeMax-Office Depot merger and Starboard Value's role as an activist hedge fund).

37. *See* Activist Investing Review, *supra* note 35, at 14 (reporting activist Elliott Management's success in winning board seats at Emulex); *see also* Ian King, *Emulex Chairman to Leave Board in Deal With Shareholders*, BLOOMBERG (Nov. 12, 2013), http://www.bloomberg.com/news/2013-11-12/emulex-says-chairman-to-leave-board-in-deal-with-shareholders.html [perma.cc/8ET5-KJSS] (announcing Emulex's $200 million buyback of 30% of its stock and the stepping down of Executive Chairman James McCluney).

38. *See* Activist Investing Review, *supra* note 35, at 15; *see also* David Benoit, *An Activist Investor Top 10: Carl Icahn Takes the Crown*, WALL ST. J. MONEYBEAT (Jan. 28, 2014, 1:02 PM), http://blogs.wsj.com/moneybeat/2014/01/28/an-activist-investor-top-10-carl-icahn-takes-the-crown/ [perma.cc/WYV8-4443] (reviewing Activist Insight's top-ten ranking of activists in its 2013 annual review).

improving corporate performance and who shares the vision the activist has for the company.

2. The Challenge in Recruiting Qualified Nominees

However, despite the importance of board representation as an activist tool and the benefits diversity of ideas and industry expertise could bring to the boardroom,[39] attracting qualified, unaffiliated, directors to serve on boards is not easy. Since most activist campaigns are met with resistance from the company and the incumbent board, unaffiliated directors will have to endure a potentially unpleasant proxy fight, and even if elected, which is far from a sure thing, they would have to enter a board where they are not wanted and then try to shake things up.[40] Indeed, it takes extra effort to recruit top-notch prospective directors for activists. According to a search firm, many good candidates decline because "they're scared of being on an activist slate," leading search firms to contact at least three times as many candidates for an activist slate as they do for a conventional board search.[41]

Traditionally, activist-nominated unaffiliated directors were not well-compensated, especially compared to the activists' general partners themselves. Historically, these nominees received a modest upfront cash payment of $50,000 for agreeing to being nominated,[42] and then, if elected,

39. ISS stated that:

[I]nvestors 'may find the new bylaw provision concerning because it could deter legitimate efforts to seek board representation via a proxy contest, particularly those efforts that include independent board candidates selected for their strong, relevant industry expertise, and who are generally recruited, but not directly employed, by the dissident shareholder. Such nominees often receive a reasonable fee for agreeing to stand for election, to compensate them for the considerable time commitments incurred in proxy contests.' ISS also argues that the bylaw could exclude highly qualified individuals, restrict the rights of investors to select suitable board members and entrench the existing board and management.

Cydney Posner, *ISS Takes on Bylaw Provision Designed to Deter Dissident Director Candidates*, COOLEY (Nov. 21, 2013), http://www.cooley.com/68696 [perma.cc/KT4U-53W8].

40. *See id*. (describing attempts to limit the service of activist directors); *ISS Releases FAQ on Corporate Bylaws That Disqualify Director Candidates Who Received Compensation from Activist Shareholders*, PWC BOARDROOMDIRECT (Jan. 2014), http://www.pwc.com/us/en/corporate-governance/publications/boardroom-direct-newsletter/january-2014-issues-in-brief.html [perma.cc/C9HF-YFA3] (discussing ISS's response to new bylaw provisions disqualifying director candidates who have received bonuses from activists).

41. *See* Joann S. Lublin, *Activists Enlist the Help of Recruiters*, WALL ST. J., Sep. 4, 2013, at B6, http://online.wsj.com/news/articles/SB10001424127887324324404579045431388717494 [perma.cc/2EES-FTKM] (discussing the growing trend of activists enlisting the help of executive-search firms in filling board seats).

42. *See Activist Investing*, HEDGE FUND LAW REPORT (Schulte Roth & Zabel), (Apr. 25,

received the regular director pay that board members of the target company received.[43] However, even though the average pay for a board position at a major company is upward of $260,000 a year,[44] these activist-nominees could not necessarily expect to get it for the long term, since in many cases the activists' goals are to bring about major changes to the company that may affect its board composition and structure, including, for example, sale of the firm. Even if the company would not make such drastic changes, these nominees were not elected as part of the management ballot, and in many cases they might not be re-nominated after the activist has departed. Thus, unlike what regular management-supported nominees might expect regarding their position's longevity (and thus forecast a higher present value for the position), these activist-nominees might assign a much lower value to their board seat. In sum, the financial rewards for being nominated on a short slate or as part of an agreement with the company have not been large.

3. The Move Towards Supplemental Pay

Juxtaposing the increased participation of activists in efforts to affect board change, which has led to greater demand for qualified candidates, with the general reluctance of these candidates to be activist nominated candidates, has led some activists to up the ante. In an attempt to attract qualified candidates, activist investors are now offering to give candidates additional compensation packages that are tied to company performance, and are not just a one-time payment, on top of any payment they get from the firm. These are equity-like arrangements, which could be substantial in their value, conditional on target company performance.

Examples of this practice have included the 2007 case of JANA/CNET, and the more recent cases of JANA/Agrium, Elliott/Hess and Third Point/Dow. In all of these cases, the activist sought to attract external candidates by offering them a piece of the future profits the

2014), http://www.srz.com/files/News/59a6c071-cf3c-45e3-af9b-25a7cf9f4d5f/Presentation/NewsAttachment/0e5a32e9-adab-4281-b996-274192d2c6a6/The_Hedge_Fund_Law_Report_Can_Activist_Hedge_Fund_Managers_Provide_Special_Compensation_to_Nomin.pdf, at 2 [perma.cc/WWH9-A6WG] (reporting an interview with the co-head of the Global Shareholder Activism practice at the law firm).

43. *See infra* Part III on director pay (describing how directors, once elected, are unhindered in their power to set their own pay in the U.S.).

44. *See* SPENCER STUART, 2014 SPENCER STUART BOARD INDEX 36 (2014), https://www.spencerstuart.com/~/media/PDF%20Files/Research%20and%20Insight%20PDFs/SSBI2014web14Nov2014.pdf [perma.cc/FR9F-EPCM] (noting that the average compensation for S&P 500 directors had amounted to $263,748 in 2014).

activist will make if the company would do well. In the case of CNET, JANA Partners, an activist hedge fund, began amassing a sizeable position in CNET's common stock.[45] By December 2007, citing CNET's management's and board's lack of urgency and expertise required to turn CNET's operations around, JANA announced that it would seek to replace two directors, amend the bylaws to expand the board by five additional directors, and nominate candidates to fill the new seats, thereby resulting in JANA nominees constituting a majority of the board.[46] In addition to the standard agreements, the agreements with four of JANA's nominees provided additional compensation in the event that they were elected as directors.[47] Specifically, the agreement entitled the nominees to 0.3% of the net profits JANA would make from investments in CNET during a three-year window. In the event that the nominees were not appointed or elected as a director of CNET, JANA agreed to pay them $50,000.[48]

45. *See* Alistair Barr, *Jana Wins Big as CBS Acquires CNet*, MARKETWATCH (May 15, 2008), http://www.marketwatch.com/story/jana-partners-wins-big-as-cbs-buys-cnet-for-45-premium [perma.cc/Z3A2-UZYE] (discussing JANA's profit from its CNET shares as a result of CBS's agreement to buy CNET).

46. *See Jana Offers Its Plan to Help Revive CNET*, N.Y. TIMES (Apr. 1, 2008), http://www.nytimes.com/2008/04/01/technology/rtcnet-web.html [perma.cc/LHH9-7PQX] (discussing the motives and proposals of a group of activist investors in bolstering the earnings of CNET). *See also JANA Master Fund, Ltd. v. CNET Networks, Inc.*, CORPORATE GOVERNANCE COMMENTARY (Latham & Watkins), May 2008, at 1, https://www.lw.com/upload/pubContent/_pdf/pub2203_1.pdf [perma.cc/P9XN-8THV] ("CNET challenged JANA's proposals on the grounds that CNET's bylaws required, among other things, that stockholders seeking to nominate director candidates or transact other business at an annual meeting own at least $1,000 worth of CNET stock for at least a year, a requirement that JANA would not have met as of CNET's June 2008 annual meeting"); John Letzing, *Battle for CNet Board Control Escalates*, MARKETWATCH (Mar. 13, 2008), http://www.marketwatch.com/story/battle-for-cnet-board-control-escalates [perma.cc/F9HX-3R7H] ("A Delaware court ruled that the firms, including Jana Partners LLC, . . . have the right to nominate directors and pursue their earlier stated goal of making changes 'to reverse CNet's ongoing underperformance.'").

47. For a sample agreement, see CNET Networks, Inc., Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 Ex. 2 (Form DFAN14A Ex. 2) (Mar. 13, 2008); CNET Networks, Inc., Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 Ex. 2 (Form DFAN14A Ex. 2) (Jan. 7, 2008).

48. *See* JANA Partners, Agreement with Jaynie Studenmund dated Dec. 23, 2007 (Form SC 13D Ex. 9) (Jan. 7, 2008) (explaining JANA will pay its nominee Jaynie Studenmund $50,000 if Studenmund is not appointed or elected as a director of CNET). See generally David Benoit & Joann S. Lublin, *Debating Activists Paying Directors*, WALL ST. J., Nov. 26, 2013, at C1, http://www.wsj.com/news/articles/SB10001424052702304281004579220094112755708 [perma.cc/SAY8-29ZR] ("Those types of awards are common and typically disclosed, activists and lawyers say. Glenview Capital Partners LP agreed to pay $100,000 each to the eight nominees it put up for the board of hospital operator Health Management Associates Inc., according to a proxy filing. Starboard Value LP agreed to compensate its three nominees for the Office Depot Inc board $20,000 in cash that was to be used to buy shares

Five years later, JANA utilized a similar strategy in its dealings with Agrium, a Canadian company based in Calgary that engages in the retail of agricultural products and services. In August 2012, JANA accumulated over 10% in Agrium, pressuring the company to return capital to shareholders and split its wholesale fertilizer and retail business.[49] After an investment bank advised against the spin-off, Agrium went public, starting a tug of war between JANA and the Board that included numerous public presentations by both sides and a $881M tender offer to repurchase shares by the company. By November, JANA had launched a proxy fight seeking the appointment of five members, including Lyle Vanclief, a former Canadian minister of agriculture, to the company's thirteen-person board.[50] Engaging in a strategy similar to the one it employed during the CNET battle, "JANA Partners disclosed that it had agreed to pay its nominees a percentage of any profit that JANA earns on its Agrium shares over a three-year period."[51] The Agrium compensation structure differed from the CNET compensation as JANA agreed to pay a percentage of its profits from its holdings in the company even if a nominee was not elected (although this would be a smaller sum than the one paid if such director were elected).

in Office Depot, according to a filing.").

49. Samantha Nielson, *Must Know: Why JANA Partners Sold Its Position in Agrium*, MARKET REALIST (Mar. 5, 2014), http://marketrealist.com/2014/03/jana-partners-sold-position-agrium/ [perma.cc/C2KB-EHKH]. *See generally* Ronald Barusch, *Dealpolitik: Agrium Lesson for Activists: Don't Underestimate the Adversary*, WALL ST. J. DEAL J. (Apr. 12, 2013, 4:08 PM), http://blogs.wsj.com/deals/2013/04/12/dealpolitik-agrium-lesson-for-activists-dont-underestimate-the-adversary/ [perma.cc/D78D-KC3S] (discussing JANA's criticism of Agrium's poor corporate governance practices and the tension formed between the two companies as a result).

50. *See, e.g.*, Stephen Erlichman, *Agrium payments don't pass the 'smell test'*, THE GLOBE AND MAIL (Toronto), (July 4, 2013), http://www.theglobeandmail.com/report-on-business/payments-dont-pass-the-smell-test/article13010420/ [perma.cc/VL6U-PCT9] (discussing the issues of Agrium's decision to pay 25 cents a share to investment advisers if their clients voted their shares in favor of the company's slate of board nominees and JANA's promise of payments to its own nominees for Agrium's board); Peter Goven, *Jana's Agrium Proxy Battle had little chance of succeeding*, FIN. POST, (Apr. 12, 2013), http://business.financialpost.com/2013/04/12/agrium-story/ [perma.cc/Z3A4-SKHP] (discussing JANA's proxy fight for seats on Agrium's board and its subsequent failure); Dan McCrum, *Agrium and Jana battle to woo investors*, FIN. TIMES (Feb. 24, 2013), http://www.ft.com/cms/s/0/bb35f07a-7d2e-11e2-8bd7-00144feabdc0.html#axzz3A7ae9BaY [perma.cc/N69N-8EJ6] (summarizing the JANA/Agrium proxy fight).

51. Allen C. Goolsby & Steven M. Haas, *Corporate Governance: Compensatory Arrangements Between Hedge Funds and Their Director Nominees*, CLIENT ALERT (Hunton & Williams), July 2013, at 1, https://www.hunton.com/files/News/4d357ef5-815e-4f2e-a9df-1172d39891b0/Presentation/NewsAttachment/24865ae7-c927-4f97-8003-d33f92880ed4/Compensatory_Arrangements_Between_Hedge_Funds_and_Director_Nominees.PDF [perma.cc/3N3Q-JDLL].

Finally, performance-based compensation was offered in the case of Hess, a major gas company[52] and the biggest target to date of Elliott, a $22 billion firm run by the billionaire Paul Singer. The hedge fund took a 4.5 percent stake in Hess,[53] launching a campaign against the company's lack of discipline and accountability, and its operational shortcomings, and calling for a breakup of the company into an international oil exploration company and a domestic driller. In response, Hess began announcing steps intended to raise its stock price, including selling its gas stations, raising its dividends, and announcing a stock buyback. It also replaced the slate of directors up for re-election this year and agreed to separate the roles of chairman and chief executive. Elliott's slate of directors for the Hess board included Rodney F. Chase, a former deputy chief executive of BP, and Harvey Golub, the former chief of American Express. Elliott also agreed to pay its nominees based on the company's success after their election.[54] In addition to a one time sum of $50,000 regardless of the outcome of the election,[55] Elliott agreed to pay each nominee, if elected, $30,000 for each percentage point Hess outperformed a benchmark based on the performance of its peer group during a three year window (but in no event more than $9,000,000).[56]

52. For a detailed review of the Hess proxy contest timeline, see *Situation Chronology: Hess Corporation And Elliott Management Corporation*, UNSOLICITED VIEWS (Morrison Foerster), 2013, http://www.mofo.com/files/Uploads/Images/UV-Hess-Elliott.pdf [perma.cc/2FVA-GRR5].

53. *See* Daniel Gilbert, *Hess, Elliott End Proxy Fight*, WALL ST. J., May 17, 2013, at B5, http://online.wsj.com/news/articles/SB10001424127887324082604578486801887211468 [perma.cc/M5LE-C9AP] (discussing the agreement between Hess and Elliott that ended their proxy fight); Michael J. De La Merced, *How Elliott and Hess Settled a Bitter Proxy Battle*, N.Y. TIMES DEALBOOK (May 16, 2013, 9:11 AM), http://dealbook.nytimes.com/2013/05/16/hess-and-elliott-settle-fight-over-companys-board/ [perma.cc/HT54-KEGB] (reporting Hess's agreement to give its opponent Elliott three board seats in exchange for the activist hedge fund's support of the company's slate of five directors).

54. *See* Daniel Gilbert & Joann S. Lublin, *Board Pay Fuels Hess Battle*, WALL ST. J., Mar. 26, 2013, at B8, http://www.wsj.com/news/articles/SB10001424127887323466204578382672296842906 [perma.cc/BPA3-CZYX] (discussing dissent shareholder's plan to give bonuses to proposed directors and the firm's negative response to it); *Elliott Management Calls for Board Shake-Up at Hess*, N.Y. TIMES DEALBOOK (January 29, 2013, 8:38 AM), http://dealbook.nytimes.com/2013/01/29/elliott-management-calls-for-board-shake-up-at-hess/ [perma.cc/UVC6-M75K] (describing Elliot's slate of directors).

55. Hess, Corp., Form of Engagement and Indemnification (Form PRRN14A Annex B) (Mar. 29 2013), http://www.sec.gov/Archives/edgar/data/4447/000104746913003661/a2214159zprrn14a.htm#le43901_annex_b [perma.cc/SW4A-FRPQ].

56. If the Total Return of the Company's common stock is 10%, and Total Return of

While the slates of the activists in each of these campaigns were filled with highly qualified nominees, in none of these battles did an activist-nominated candidate get a board seat with the incentive package. In the case of JANA/CNET, CNET sold itself before the election, allowing JANA to reap a nice premium on its investment. In the JANA/Agrium battle, JANA lost its fight and in the Elliot/Hess case, the pay deal was dropped as part of a settlement with the company that negated the need for contested elections.[57]

That landscape has changed in the recent campaign of Third Point, an activist hedge fund headed by Dan Loeb with over $4 billion under management,[58] against Dow Chemical Co., one of the marquee industrial companies in the U.S. Third Point had been pushing Dow to spin off its lucrative but slow-growing petrochemical business and focus on specialty materials. After talks with the company over board representation initially failed, Third Point filed intent to launch a proxy fight and announced that it had reached a compensation agreement with two nominees: former Foster Wheeler AG CEO Raymond Milchovich and Steve Miller, the non-executive chairman of AIG.[59] Under the agreement with the nominees, each has received a cash payment from Third Point equal to $250,000 in consideration for his agreement to serve as a nominee, each will be entitled to an additional cash payment of $250,000 if appointed as a director of the Company, and each may be entitled to two additional cash payments from Third Point under certain circumstances based upon the appreciation of Third Point stock holdings in the company after three and five years of service on the board, respectively. Each nominee has agreed to hold at least $250,000 of Common Stock of Dow during their tenure.[60]

On November 21, 2014, Dow announced that it had agreed to add to

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the Benchmark Peer Group is 5%, then the Hess Outperformance Percentage would be 5% and the payment to the director would be $150,000. *See* Gilbert & Lublin, *supra* note 54 ("Elliott says it will pay its successful nominees $30,000 for every percentage point Hess stock outperforms a group of peers over three years. If Hess stock betters its peers by 10% over that period, the Elliott-nominated directors would reap $300,000 from the hedge fund in addition to their board fees.").

57. Gilbert, *supra* note 53 (discussing the agreement between Hess and Elliott that ended their proxy fight and the further questions the revamped board raises); Goven, *supra* note 50 (describing the vote that ended the JANA/Agrium contest)

58. *Dan Loeb Bio, Returns, Net Worth*, INSIDER MONKEY (Dec 26, 2014), http://www.insidermonkey.com/hedge-fund/third+point/16/ [perma.cc/45QV-GQW3].

59. Dow Chem. Co., Proxy Statement (Form DFAN 14A) (Nov. 13, 2014), http://www.sec.gov/Archives/edgar/data/29915/000119312514411370/d818689ddfan14a.htm [perma.cc/Q6Y6-VQ5P].

60. Dow Chem. Co., Proxy Statement (Form DFAN 14A) (Nov. 13, 2014), https://www.sec.gov/Archives/edgar/data/29915/000119312514411302/d820869ddfan14a.htm [perma.cc/D9EC-ZSMP].

the board the two Third Point nominees under an agreement with Third Point, making these nominees the first to sit on a board while having a side payment agreement in place with an activist.[61]

4. The Hysteria Over Supplemental Pay

In all of these cases, defenders of management were very critical of the new compensation structure. Agrium's chairman raised concerns regarding the independence of the JANA nominees by financially "leashing" them to JANA, "thus incentivizing them to make decisions that may diverge from the best interests of all of Agrium's shareholders."[62] In doing so, Agrium coined the term "golden leash" with respect to these compensation structures.[63] Similar arguments were raised by Hess in its battle with Elliot,[64] and in the case of Provident Financial Holdings, which adopted a bylaw attempting to limit such compensation structures and said that the "trend of activists attempting to pay board members is 'disconcerting . . . primarily due to the potential for creating a board composed of directors with distinctly different motivations.'"[65] The negative view of these structures was not solely confined to management and incumbents, as some prominent academics were very critical of these arrangements. Prof. Bainbridge commented that "[i]f this nonsense is not illegal, it ought to be,"[66] while Prof. Coffee stated that "[t]hird party bonuses create the wrong incentives, fragment the board, and imply a shift

61. *See* David Benoit & Joann S. Lublin, *Dow Chemical, Activist Strike a Deal*, WALL ST. J., Nov. 21, 2014, at B3, http://www.wsj.com/articles/dow-chemical-third-point-settle-board-dispute-1416578708 [perma.cc/8MYT-2E74] (summarizing the agreement between Dow and Third Point).

62. Saeed Teebi, *Canada: ISS Pulls The Golden Leash, But Has It Gone Too Far?*, MONDAQ (Feb. 3, 2014) http://www.mondaq.com/canada/x/290618/Shareholders/ISS+Pulls+The+Golden +Leash+But+Has+It+Gone+Too+Far [perma.cc/7672-4AP5].

63. Mr. Zaleschuk said in a letter to Agrium shareholders that "[t]his kind of 'golden leash' arrangement is unheard of in Canada and raises serious questions about the independence of Jana's nominees and their ability to act in the best interests of all shareholders[.]" Janet McFarland, *Jana's Agrium Pay Scheme Draws Fire*, THE GLOBE AND MAIL (Toronto), Mar. 5, 2013, at B5, http://www.theglobeandmail.com/globe-investor/janas-agrium-pay-scheme-draws-fire/article9256064/ [perma.cc/UH97-TH89].

64. For example:

'There are tremendous conflicts [when] someone else is paying your directors to achieve goals,' said Paul Lapides, head of the Corporate Governance Center at Kennesaw State University. 'Elliott's nominees cannot claim independence as they have agreed to be paid directly by Elliott to support the hedge fund's short-term agenda,' a Hess spokesman said.

Gilbert & Lublin, *supra* note 54.

65. Benoit, *supra* note 3.

66. Bainbridge, *supra* note 4.

toward both the short-term and higher risk[,]" and that the "end does not justify the means."[67]

While the initial debate regarding these payments was focused on the specific proxy battles described above, the activists' adversaries have expanded their canvas of opposition to such payments. Wachtell, Lipton, Rosen & Katz LLP—a law firm long noted for its work defending companies against activists—has urged companies to adopt bylaws that would bar from a board any candidate who has been paid for board candidacy or service by an outsider. "A Wachtell memo warned about 'poisonous conflicts' arising from 'creating a subclass of directors.'"[68] Following that call, Wachtell has developed bylaw language disqualifying outside payments to directors and has advocated for its adoption by companies.[69] Thirty-three companies had adopted such language as of November 30, 2013.[70]

However, the effort to insulate boards through these proposed bylaws has appeared to stall out, as it faced strong opposition. ISS, an influential proxy advisory firm, criticized it, stating it may recommend against, or withhold vote of, boards that adopt such measures.[71] Similarly, Glass Lewis followed suit, stating that it will recommend that shareholders vote against members of the corporate governance committee at annual meetings if the board has adopted a bylaw that disqualifies director nominees with outside compensation arrangements and has done so without

67. Coffee, *supra* note 5 and accompanying text.

68. Benoit & Lublin, *supra* note 48.

69. Martin Lipton, *ISS Publishes Guidance on Director Compensation (and Other Qualification) Bylaws*, THE HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Jan. 16, 2014), https://blogs.law.harvard.edu/corpgov/2014/01/16/iss-publishes-guidance-on-director-compensation-and-other-qualification-bylaws/ [perma.cc/XW5G-NQZW]; *see also Investors Paying Directors? Have At It*, THE ACTIVIST INVESTOR BLOG (Dec. 3, 2013), http://www.theactivistinvestor.com/The_Activist_Investor/Blog/Entries/2013/12/3_Director_Compensation.html [perma.cc/M8GV-D28R] ("Around the time of the Hess annual meeting, Wachtell, Lipton shopped a bylaw amendment that limits significantly how shareholders can compensate directors.").

70. *See* Carl Ichan, *Disqualifying Dissident Nominees: A New Trend in Incumbent Director Entrenchment*, THE HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Feb. 12, 2014), http://blogs.law.harvard.edu/corpgov/2014/02/12/disqualifying-dissident-nominees-a-new-trend-in-incumbent-director-entrenchment/ [perma.cc/9D56-XRNU] ("[T]hirty-three (33) public companies had unilaterally (i.e. without shareholder approval) amended their bylaws to include a Director Disqualification Bylaw.").

71. *Director Qualification/Compensation Bylaw FAQ*, ISS 1, 1 (Jan. 13, 2014), https://www.issgovernance.com/file/files/directorqualificationcompensationbylaws.pdf [perma.cc/YL8X-R4EV] (suggesting ISS may not support restrictive director qualification bylaws); *see also* Lipton, *supra* note 69 (noting ISS disapproval of restrictive director bylaws); Lipton, *supra* note 5, at 2 ("ISS faulted the Provident board for adopting this director qualification bylaw unilaterally.").

seeking shareholder approval.[72] The proxy advisory firms' stand has led to a stall in the adoption of the bylaw in other companies and to a reversal of course in other companies. Two early adopters of the Wachtell bylaw withdrew it altogether[73] and other adopters faced stiff criticism following their move.[74]

II. HOW ARE DIRECTORS PAID NOW?

So far, this Article has provided factual background regarding payments to activist-paid directors and the controversy these payments sparked. Before proceeding, it is important to understand how directors are compensated now, whether shareholders truly participate in setting their pay, and how directors' current pay structure may impact their performance.

A. *Directors Decide How to Pay Themselves With Shareholders' Money*

Under the current legal arrangements in most states, the responsibility and authority to set director pay lies with the board itself.[75] This practice allows directors in U.S. public companies to decide how to pay themselves, using shareholders' money, how that pay is structured, what additional perks and benefits they will receive, and more. While historically, directors were not expected to withdraw salaries from the corporation,[76] in

72. Jack Ferdon, *Restrictions on Compensation for Dissident Nominees Encounter Shareholder Opposition*, GLASS LEWIS & CO. (Feb. 6, 2014), http://www.glasslewis.com/blog/restrictions-compensation-dissident-nominees-encounter-shareholder-opposition/ [perma.cc/ZWV6-M225].

73. The boards of both International Game Technology and Schnitzer Steel Industries repealed similar provisions just months after inserting them into their bylaws. *Id*.

74. Provident Financial Holdings was the first among the companies approving the bylaw to hold an annual meeting and three directors up for reelection faced negative recommendation from ISS because they approved the bylaw change without a shareholder vote, because of the "'lack of a compelling explanation from the board,'" and the concern that putting a broad restriction on compensation could lead to the exclusion of high-quality individuals from the board. Gilbert & Lublin, *supra* note 68.

75. 8 Del. Code Ann. 1953, § 122 (2015). *See also* 8 Del. Code Ann. 1953, § 141(h) (2015) ("Unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to fix the compensation of directors."). Similar statues allowing the board to set its own compensation are found in the Model Business Corporation Act and in the majority of the different state business codes. *See* Charles Elson, *Director Compensation and the Management-Captured Board- The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 135-156 (1996) (giving a historical overview of director compensation).

76. *See* Elson, *supra* note 75, at 136 (stating that, in the past, it was not common for

recent decades, following the increased demands of the job, that expectation has changed into a reality whereby director pay is fairly significant.[77] And while shareholders can, in theory, amend the bylaws of the corporation to limit the board's power to set its own compensation,[78] shareholders have not done so, as this entails costs that most shareholders refuse to incur.

1. Director Pay in the US

According to a 2014 Spencer Stuart survey, the average director compensation in the S&P 500 is $263,748.[79] As further detailed in Table 1 below, 59% of the typical average director compensation package is paid in equity that is tied directly to the company's performance—53% as stock grants and 5% as options.[80] Examining the individual director breakdown further reveals that while the total compensation in the S&P 500 is $249,590 for the year 2013, 40% of the directors in the S&P 500 earn above the average.[81] And while most directors are close to the average, 272 (6%) directors in S&P 500 companies earned more than $400,000 and 134 directors (3%) made more than $500,000 in 2013.[82]

directors to be paid a salary).

77. *See, e.g.*, Katherine Brown, Note, *New Demands, Better Boards: Rethinking Director Compensation in an Era of Heightened Corporate Governance*, 82 NYU L. REV. 1102, 1119 (2007) (noting Coca-Cola's director compensation plan); Jeff Green and Hideki Suzuki, *Board Director Pay Hits Record $251,000 for 250 Hours*, BLOOMBERG BUSINESS (May 30, 2013), http://www.bloomberg.com/news/2013-05-30/board-director-pay-hits-record-251-000-for-250-hours.html [perma.cc/4ET7-Y8Q5] ("Pay for directors at Standard & Poor's 500 Index companies rose to a record average of $251,000 last year. . . .").

78. *See* Michael S. Melbinger, *Shareholder Say on Director Pay?*, WINSTON & STRAWN LLP (Jan. 4, 2012) http://www.winston.com/en/executive-compensation-blog/shareholder-say-on-director-pay.html [perma.cc/ZGV7-SGYV] ("Shareholders already have considerable influence over the Board and its policies through their ability to elect the Company's directors on an annual basis.").

79. SPENCER STUART, *supra* note 44, at 7.

80. *Id*. at 36.

81. *See* S&P CAPITAL IQ, COMPUSTAT EXECUTIVE COMPENSATION-DIRECTOR COMPENSATION (June 30, 2014) (on file with author) (containing data from which this breakdown is derived).

82. *Id*. The main factors attributing to the variance in director pay are related to the directors' roles on the board, i.e. whether the director serves as a chair or on one of the board committees, or chooses to receive compensation in equity and not cash. *See, e.g.*, HEWITT, 2010 ANALYSIS OF OUTSIDE DIRECTOR COMPENSATION 4 (2010), http://www.aon.com/attachments/thought-leadership/2010_Outside_Director_Compensation.pdf [perma.cc/SJZ4-7TNU] (noting different fees for different types of board service).

Table 1: Director Pay by the Numbers (2014)[83]

Total average compensation	$263,748
Average annual retainer	$107,383
Boards paying board meeting fee	25%
Average board meeting fee	$2,229
Boards offering stock option program for directors	18%
Boards paying equity in addition to retainer	76%

Table 2: the Average Director Compensation in the S&P 500 (2013-2014)[84]

	Average (in $)	Highest Paid Director [85] (in $)	Highest Paid Cash Fees[86] (in $)
Fees Earned or Paid in Cash	92,060	0	941,180
Value of Stock Awards	117,680	13,330,030	101,400
Value of Option Awards	21,400	0	0
Non-Equity Incentive Plan Compensation	410	0	0
Change in Pension Value and Nonqualified Deferred Compensation Earnings	2,400	0	26,404
All Other Compensation	15,650	0	5,279
Total Compensation - As Reported in SEC Filings	249,590	13,330,030	1,074,269

83. SPENCER STUART, *supra* note 4479, at 9.
84. S&P CAPITAL IQ, *supra* note 81.
85. P. Roy Vagelos from Regeneron Pharmaceuticals.
86. Milton Carroll from Centerpoint Energy, Inc.

2. Director Pay Outside the US

The American landscape stands in sharp contrast to other jurisdictions, where pay levels are lower[87] and shareholders must approve director pay. In the United Kingdom,[88] a 2013 reform now requires companies to have a directors' remuneration policy (which also includes a separate, forward-looking remuneration policy section) that must be approved by shareholders at least every three years.[89] In addition, all payments made to directors must be consistent with the policy, and if not, must be separately approved by shareholders. Large- and medium-sized companies must also explain, with respect to the director's actual performance, how each element of the director's remuneration package supports the short- and long-term strategy of the company, its potential value, and the basis upon which such company has made decisions on the level of variable pay that is received.[90] Swiss public companies, following the Minder Initiative, are now similarly obligated to receive shareholder approval for director compensation and are outright prohibited from providing certain types of compensation to directors.[91] Germany, Italy, and Sweden have similar

87. A report prepared by the Hay Group finds that while director remuneration and fee policy varies widely across Europe, the median basic policy fee paid to directors across Europe is €64,800, with fees for Austrian directors the lowest at €15,000 and for Swiss directors the highest at €197,400. HAY GROUP, NON-EXECUTIVE DIRECTORS IN EUROPE 2014 1, 5 (Dec. 2014).

88. For an investigation of the relationship between shareholder voting and executive compensation levels in the United Kingdom, see generally Martin Conyon & Graham Sadler, *Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK*, 18 CORP. GOVERNANCE: AN INT'L REV. 296 (2010).

89. Sinead Kelly, *Recent Developments in Corporate Governance October 2013*, A&L GOODBODY (Oct. 8, 2013), http://www.algoodbody.com/knowledge.jsp?i=3672 [perma.cc/VZK2-XGX2]. The new mandatory process of the 2013 legislation moves away from the advisory vote that was introduced in 2002. *See* Conyon & Sadler, *supra* note 88, at 296 (discussing the regulations enacted in 2002 requiring a shareholder advisory vote on director compensation).

90. *See* Kelly, *supra* note 89 (summarizing the provisions of the Enterprise and Regulatory Reform Act 2013 and The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013); *see also* Chris Mallin et al., *The Remuneration of Independent Directors in the UK and Italy: An Empirical Analysis Based on Agency Theory*, 24 INT'L BUS. REV. 175, 177 (2014) ("In relation to [independent non-executive directors'] remuneration, the UK Corporate Governance Code states that remuneration for non-executive directors should reflect their time commitment and responsibilities. It should not include share options or other performance-related elements. If, exceptionally, options are granted, shareholder approval should be sought in advance as holding share options could be relevant to the determination of a non-executive director's independence.").

91. *See* Oliver Triebold et al., *The Implementation of the Minder Initiative: Ordinance Against Excessive Compensation in Listed Joint Stock Companies*, SCHELLENBERG WITTMER 1-3 (Nov. 2013), http://www.swlegal.ch/Publications/Newsletter/The-Implementation-of-

requirements, following the British and Swiss examples,[92] and in recent months the European Union ("EU") has presented a union-wide proposal for similar measures.[93]

While the EU has elected to require shareholder approval ex-ante, Australia's 'two-strikes' rule adopted in 2011 similarly presents an effective voice for shareholders regarding director pay, but in an ex-post manner. Under the rule, if 25% of shareholders vote against a company's remuneration report at two consecutive annual general meetings, the entire board may have to stand for re-election within three months.[94]

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the-Minder-Initiative-Ordina.aspx [perma.cc/86WE-P5TT] (explaining the provisions of the ordinance and identifying advance compensation, incentive payments for restructurings, and severance pay by contract as impermissible compensation); *Swiss Voters Go For Binding Say-on-Pay: Strenuous Compensation Restrictions To Be Imposed In Renown Free Market*, PAY GOVERNANCE LLC, http://paygovernance.com/swiss-voters-go-for-binding-say-on-pay-strenuous-compensation-restrictions-to-be-imposed-in-renown-free-market-2 [perma.cc/XS5R-GVHZ] (last visited Nov. 10, 2015) (detailing the requirements and prohibitions embodied in the text of the Minder Initiative).

92. Guido Ferrarini et al., *Corporate Boards in Italy*, *in* CORPORATE BOARDS IN LAW AND PRACTICE: A COMPARATIVE ANALYSIS IN EUROPE 66, (Paul Davies et al. eds., 2013). *See also* Jan Lieder & Philipp Fischer, *The Say-on-Pay Movement—Evidence From a Comparative Perspective*, 8 EUR. COMPANY & FIN. L. REV. 376, 384-86 (2011) (describing Germany's adoption of an optional, non-binding say-on-pay rule in 2009 with reference to Sweden's adoption of a similar say-on-pay rule in 2006). *See generally* Guido Ferrarini et al., *Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis* (European Corporate Governance Inst., Working Paper No. 126/2009, 2009), *available at* http://ssrn.com/abstract=1418463 [perma.cc/C9XX-JD5R] (discussing the adoption of say-on-pay rules in Europe).

93. *See* Emily Chasan, *European Commission Proposes Binding Say-on-Pay*, WALL ST. J. CFO J. (Apr. 9, 2014, 2:47 PM) http://blogs.wsj.com/cfo/2014/04/09/european-commission-proposes-binding-say-on-pay/ [perma.cc/P35G-M9LD] ("The European Commission on Wednesday proposed measures aimed at giving more rights to shareholders, including a binding 'say- on- pay' shareholder vote on executive compensation."); James Kanter, *European Official Urges 'Say on Pay' Requirements for Boards*, N.Y. TIMES DEALBOOK (Apr. 9, 2014, 3:15 PM) http://dealbook.nytimes.com/2014/04/09/european-official-urges-requirement-for-shareholder-vote-on-director-pay/?_php=true&_type=blogs&_r=0 [perma.cc/M37P-H7VV] ("A European Union official renewed his efforts to curb excessive pay by introducing a plan [recently] that would require a shareholder vote on salaries for directors of publicly traded companies."); *Say on Pay Proposals from Europe*, LINKLATERS (Apr. 15, 2014) http://www.linklaters.com/Publications/Employment-and-Incentives/Remuneration/Pages/Say-on-pay-proposals-Europe.aspx [perma.cc/PBA4-YN8Z] (outlining the proposal requirements and legislative timeline).

94. Reza Monem & Chew Ng, *Australia's "Two-Strikes" Rule and the Pay-Performance Link: Are Shareholders Judicious?*, 9 J. OF CONTEMP. ACCT. & ECON. 237, 239-40 (2013) (describing the key features of Australia's "two-strikes" say-on-pay rule); Matt Orsagh, *"Say on Pay": How Voting on Executive Pay Is Evolving Globally — and Is It Working?*, CFA INST. (Dec. 26, 2013), http://blogs.cfainstitute.org/marketintegrity/2013/12/26/say-on-pay-how-votes-on-executive-pay-is-evolving-globally-and-is-it-working/ [perma.cc/VW6B-H9EA]

B. *Director Pay as a Function of Director Tenure*

The issue of directors' unchecked power to set their own pay in the U.S. is further augmented by directors' firm grip on their seats. Because director elections in the U.S. are rarely contested, each director not only controls the level of her pay, but also the duration of it. This provides directors not only with discretion regarding their annual pay, but also their future expected value since they can also decide for how long they will receive this pay stream.

It is no surprise then that the average board tenure for the entire S&P 500 composite in 2013 is 8.69 years, or that on the individual director level, the number of directors in the S&P 500 with very long tenure is also significant. For the year 2012 the number of S&P 500 directors with tenure exceeding fifteen years was 720, which was approximately 14% of the directors sampled, and the director with the longest tenure has served for fifty years. These figures are further corroborated by the low turnover rate of directors, as the average turnover of board members and appointment of new directors has decreased in recent years: the number of new appointees has dropped by 12% over the past five years and by 27% over the past ten years. In 2012, the number of new independent directors fell to 291, which consists of around 5% of the directors in the S&P 500, the lowest number documented since 2001.[95]

(contemplating the effectiveness of say-on-pay rules in various jurisdictions across the globe, including Australia).

95. Data for the year 2012 was obtained from the BoardEx database, which contains various statistics on all public companies in the U.S., including average board tenure for the years 2003-2012. BOARDEX, BOARDEX DATA (Mar. 28, 2013) (on file with author). This data was further corroborated by similar data that was obtained from the RiskMetrics data file for the years 2007-2012. INST. S'HOLDER SERV. INC., RISKMETRICS GROUP (on file with author). Data was also obtained from several reports. KORN/FERRY INT'L, 33RD ANNUAL BOARD OF DIRECTORS STUDY (Aug. 19, 2008), http://www.kornferryinstitute.com/reports-insights/33rd-annual-board-directors-study [perma.cc/TDX3-KMTY]; SPENCER STUART, 2010 SPENCER STUART BOARD INDEX (2010); GEORGESON, 2012 ANNUAL CORPORATE GOVERNANCE REVIEW (2012), http://www.computershare-na.com/sharedweb/georgeson/acgr/acgr2012.pdf [perma.cc/VX4A-WAFB]; SPENCER STUART, 2012 SPENCER STUART BOARD INDEX (2012); SPENCER STUART, 2013 SPENCER STUART BOARD INDEX (2013); PRICEWATERHOUSECOOPERS, INSIGHTS FROM THE BOARDROOM 2012: BOARD EVOLUTION: PROGRESS MADE, YET CHALLENGES PERSIST, ANNUAL CORPORATE DIRECTORS SURVEY (2012), http://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/assets/pdf/pwc-annual-corporate-directors-survey.pdf [perma.cc/L4Z3-SEB6]; *2015 Corporate Governance & Executive Compensation Survey*, SHEARMAN & STERLING, http://shearman.uberflip.com/i/581509-2015-corporate-governance-executive-compensation-survey [perma.cc/ENK2-SRTR] (last visited Nov. 10, 2015).

Table 3: Board Tenure per Company (S&P 500)[96]

Year	Average Board Tenure in all S&P 500 Firms (years)	Average board tenure per company <5 years	Average board tenure per company is between 6-10 years	Average board tenure per company is between 11-15 years	Average board tenure per company >15 years
2012	8.67	14%	64%	18%	4%
2013	8.69	18%	62%	16%	4%

Table 4: Individual Director Tenure (S&P 500)[97]

Year	Average Director Tenure in all S&P 500 Firms	Number (%) of directors with tenure <5 years	Number (%) of directors with tenure between 6-10 years	Number (%) of directors with tenure between 11-15 years	Number (%) of directors with tenure >15 years
2012	8.67	1609 (31.5%)	197 (38.5%)	804 (16%)	720 (14%)

In sum, with an annual pay that ranges between $200,000 and $400,000 and average tenure of 8.7 years, a director could receive expected compensation from her position that ranges from $2 million to $3 million.

C. *Do Shareholders Implicitly Set Director Pay?*

While shareholders may not have an explicit say regarding director compensation, one can argue that shareholders implicitly set director pay because they can choose to not elect directors who excessively compensate themselves. In reality, however, most elections go uncontested, with directors not removed against their will.[98] For example, in 2013 there were only thirty-five contested elections in companies in the Russell 3000, and

96. *See supra* note 95 and accompanying text (noting data sources).
97. *See supra* note 95 and accompanying text (noting data sources).
98. *See* Bebchuk, *supra* note 7, at 701-02 ("[M]ost elections will likely be uncontested. . . . Under existing default arrangements, shareholders do not have any meaningful power to veto candidates put forward by the board in an uncontested election.").

only fourteen of those elections were in companies with a market cap exceeding $1 billion.[99] Even within the subset of contested elections, in most cases an agreement with the board was reached prior to the actual elections, reducing the threat to incumbent directors. Moreover, although contested elections are on an upward trend[100] and have seen an increased success rate,[101] and while they may impact the career of a target company director,[102] they are still a drop in the bucket as they occur at only slightly over one percent of the companies in the Russell 3000 index.[103]

Similarly, one might argue that majority voting, a trend that has been gaining steam in corporate governance[104] and that some institutional investors consider to be the focal point of their governance strategy, could have contributed to an effort to make directors more accountable to

99. THE CONFERENCE BOARD, CHART OF THE WEEK: PROXY CONTESTS BY INDEX AND REASON (Oct. 2013), https://www.conference-board.org/retrievefile.cfm?filename=TCB-CW-032.pdf&type=subsite [perma.cc/5R6W-NKFL]; *see also* John Lovallo, *Proxy Contests on the Rise–Activists Emboldened by Success*, LEVICK DAILY (Oct. 28, 2013), http://levick.com/blog/2013/10/28/proxy-contests-rise-%E2%80%93-activists-emboldened-success [perma.cc/LQR8-J4RM] (analyzing the 2013 proxy season).

100. *See* Lovallo, *supra* note 99 ("[A]ctivist shareholders are driving a significant uptick in proxy contests. During the first half of 2013, Russell 3000 companies saw more than a 45% spike over the same period last year.").

101. *See* Lisa M. Fairfax, *The Model Business Corporation Act at Sixty: Shareholders and Their Influence*, 74 LAW & CONTEMP. PROBS. 19, 25 (2011) ("In recent years not only has there been an increase in proxy fights, but there also has been an increase in the relative success of such fights.").

102. *See* Vyacheslav Fos & Margarita Tsoutsoura, *Shareholder Democracy in Play: Career Consequences of Proxy Contests*, 114 J. OF FIN. ECON. 316, 317 (2014) ("[P]roxy contests are associated with significant adverse effects on the careers of incumbent directors. Following a proxy contest, incumbents lose seats from on targeted boards. . . . Furthermore, following a proxy contest, directors experience a significant decline in the number of seats on other boards. . . . Overall, facing a direct threat of removal is associated with $1.3–$2.9 million in foregone income until retirement for the median incumbent director.").

103. *See* BEBCHUK & WEISBACH, *supra* note 6, at 327 ("In recent years, the most important players in the activism landscape have been activist hedge funds. . . . Unlike activist shareholders who mounted proxy fights and takeover bids in the past, the activist hedge funds that attracted the limelight in the past decade . . . try to affect the way in which the company is run or to get the company to be acquired by someone else."); Fairfax, *supra* note 101, at 25 (suggesting the upward trend of proxy fights may be shifting); *see also* John Laide, *Proxy Fight Season*, SHARKREPELLENT.NET (Feb. 4, 2010), https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20100204.html&ProxyFight_Season&rnd=284029 [perma.cc/U6H5-NVFY] (noting an average of 53 annual proxy fights between 2006 and 2009).

104. Roughly 80% of the companies in the S&P 500 have a majority voting policy in place. *See* Holly J. Gregory, *Trends in Director Elections*, PRAC. L. 20 (Sept. 2, 2012) ("[A]bout 80% of S&P 500 companies have since adopted some form of majority voting, with many companies adopting it voluntarily to avoid a high vote on a shareholder proposal.").

shareholders by presenting a realistic possibility of directors losing their seat, even in uncontested elections, if they failed to achieve majority support. However, in many cases directors could still be retained by the company even if required to resign and such resignation was tendered.[105] Indeed, in practice, majority voting is of limited use; a recent study finds that:

> [A]mong the 60,920 director elections held at Russell 3000 companies during the three years 2010, 2011, and 2012, in 176 cases (0.3%) directors failed to achieve a majority of votes cast in director elections conducted under any voting format.[106]

In addition, nearly 85% of the directors of public companies that did not receive a majority of votes are still on the board two years later.[107]

Hence, the only effective way that directors can be removed, without cause, is through a proxy fight, usually brought by an activist investor. This is the value activists bring to the table, and why they are generally supported by institutional investors.[108]

105. For a critique regarding the current affair of majority voting, see *Letter from Jeff Mahoney, Gen. Counsel, CII to John Carey, Vice President-Legal, NYSE Regulation, Inc.*,(Jun. 20, 2013), http://www.cii.org/files/issues_and_advocacy/correspondence/2013/06_20_13_cii_letter_nyse_majority_voting.pdf [perma.cc/L5B7-NURC]. Recent empirical studies are conflicted about whether majority voting in its current form even carries value. *Compare* Jay Cai et al., *A Paper Tiger? An Empirical Analysis of Majority Voting*, 21 J. OF CORP. FIN. 119, 133 (2013) ("[F]irms that adopt majority voting do not experience changes in director votes, director turnover, or improvement in performance. The bulk of our evidence, with the exception of the positive announcement returns for the majority voting proposals, is consistent with the paper tiger hypothesis: majority voting has no significant impact on director election, firm performance, and shareholder wealth."), *with* Yonca Ertimur et al., *Does the Director Election System Matter? Evidence from Majority Voting*, 20 REV. OF ACCT. STUD. 1, 1 (2015) ("Overall, it appears that, rather than a channel to remove specific directors, director elections are viewed by shareholders as a means to obtain specific governance changes and that, in this respect, their ability to obtain such changes is stronger under a [majority voting] standard.").

106. ANNUAL SHAREHOLDER MEETINGS AND THE CONUNDRUM OF "UNELECTED DIRECTORS", COMM. ON CAPITAL MKTS. REGULATION 1 (Jun. 23, 2014), http://capmktsreg.org/app/uploads/2014/06/CCMR-Unelected-Directors-Statement-2014-06-23.pdf [perma.cc/2RGG-7R39].

107. *Id.* at 2.

108. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 897 (2013) ("[Activist investors] are governance entrepreneurs, arbitraging governance rights that become more valuable through their activity monitoring companies to identify strategic opportunities and then presenting them to institutional investors for their approval—through a proxy fight, should the portfolio company resist the proposal. By giving the institutions this choice, the activists increase the value of governance rights; the institutions' exercise of governance rights then becomes the mechanism for creating value for beneficial owners."). *See also supra* note 24 and accompanying text (noting that there is

III. THE BENEFITS OF ACTIVISTS SUPPLEMENTING DIRECTOR COMPENSATION WITH PERFORMANCE-BASED PAY

Since shareholder activism, particularly the type conducted by hedge funds, has been shown to be beneficial,[109] shareholders should be interested in facilitating effective activist campaigns. Even those who might be skeptical regarding the value of activists' turnarounds in general or the value of a specific campaign should be interested in facilitating a framework in which the activist can take its best shot at convincing shareholders to support its campaign. That, in and of itself, should lead incumbent directors and management to better their own performance as well as providing shareholders with a larger pool of nominees, a selection that should improve the board in the long run.[110] As this Part will detail, allowing activists to appoint non-affiliated directors, and particularly qualified talent, is germane to both shareholders and activist interests. In that context, paying directors helps recruit talent that would otherwise not serve on a board for regular director pay, and structuring it as performance-based pay serves a number of useful functions that may not be achieved by fixed compensation.

A. *Why is There A Need for Non-Affiliated Directors?*

As a preliminary matter, one might ask why activists need to attract and recruit outside candidates, instead of securing their own seats. Indeed, many activists nominate themselves to serve on boards in which they are active.[111] However, in many cases having a non-affiliated director,

a debate over the merits of increased shareholder activism in the governance of widely held corporations).

109. *See infra* Part II.A.2 (discussing the beneficial effects of shareholder activism as supported by recent studies).

110. Granted, a reoccurring line of argument claims that the costs of fighting the activists and the damage to board cohesiveness would make shareholders worse off. However, there are strong reasons to doubt the strength of these arguments in the specific context of board supplemental pay. First, if activists are going to launch proxy fights with or without these paid-directors, then shareholders are better off with the better candidates, all other things held equal. Similarly, if shareholders elect to side with the activist, assuming board cohesiveness is at risk (an assumption that this Article doubts), there again, shareholders are better off with the better candidates. Moreover, incumbent directors are more likely to get along with independent candidates rather than the activist fund's general partners, which is another strong argument favoring activist-paid directors.

111. There are numerous cases where this is the standard approach of the activist. *See, e.g.*, Steve Schaefer, *Bill Ackman Says J.C. Penney Board Is 'Flying Blind,' Chairman Needs To Go*, FORBES (Aug. 9, 2013), http://www.forbes.com/sites/steveschaefer/2013/08/09/ackman-j-c-penney-board-is-flying-blind-chairman-needs-to-go/ [perma.cc/8JGS-YNQ5] (describing Pershing Square's appointment of Bill Ackman to the board of J.C.

especially a talented candidate, is the better outcome for both the activist and shareholders. In these cases, recruiting the most qualified non-affiliated director should be the preferred way, rather than filling the seat with the activist itself or appointing a less suitable outside candidate. As explained below, both the attributes that the non-affiliated director could bring to the table and the structure of the activist itself provide strong justifications for the appointment of non-affiliated directors.

Industry Expertise

While activists are savvy businessman, they are, for the most part, lacking actual experience in traditional corporate work. Moreover, activists often target different companies from different industries. While the activists' expertise in financial structuring and 'governance know-how' could translate into many different industries, they are still lacking in the day-to-day know-how of the specific business they are targeting. Placing a nominee who agrees with the activist's general turnaround road-map, but also has the ability to provide specific input regarding the more unique aspects of the business, would add value to the activist plans and to the company and its board, and in turn would serve all shareholders, including the activist itself.

Resource Allocation

Since most activist hedge funds have a small ledger of partners, outsourcing the board seat nomination is, in many cases, the preferred route from the perspective of time and resource allocation. By nominating a non-affiliated director, the activist is unencumbered by the duties and responsibilities of the board position. Therefore, the activist is free to focus on more targets than it otherwise would have targeted if it had to sit at each of the firms with its equity positions.

The Benefits of Separation

The separation between directors and activists, created by the appointment of non-affiliated directors, has several benefits. Specifically, even if a given activist had the necessary industry expertise and the time to sit on the board, it still could be useful for the activist to create separation

Penney); Phil Wahba, *Activist Investor Jana's Biggest Get Yet: 2 Walgreen Board Seats*, FORTUNE (Sep. 8, 2014), http://fortune.com/2014/09/08/jana-walgreen-board-seats/ [perma.cc/R4GM-GADF] (discussing how JANA Partners' founder and managing partner Barry Rosenstein is on the board of Walgreen, of which he is also an activist investor); Richard Waters, *Microsoft Cedes Board Seat to ValueAct*, FIN. TIMES, (Aug. 30, 2013), http://www.ft.com/cms/s/0/d4b2cafa-11c1-11e3-a14c-00144feabdc0.html#axzz3zGQxf2jq [perma.cc/2VKZ-KFFQ] (discussing the appointment of a ValueAct general partner to the board of Microsoft).

between itself and the position of the board nominee.

First, non-affiliated directors are useful because they allow activists to continue trading in the shares of the company and other companies in the industry, without insider trading concerns.[112] Similarly, activists may prefer the appointment of an independent director since if they appoint one of their employees, the "director by deputization theory" could subject them to Section 16(b) of the Securities Exchange Act of 1934 that prohibits short-swing profits.[113] Hence, this limits the activists' ability to trade in the company stock.

Third, activists might suffer from internal conflict of interests, or could be otherwise ineligible to perform their duties as board members, due to board restrictions on other board memberships.[114]

112. *See Hushmail: Are Activist Hedge Funds Breaking Bad?*, M&A COMMENTARY (Latham & Watkins), Jun. 23, 2014, at 3, http://www.lw.com/thoughtLeadership/lw-activist-investors-hushmail [perma.cc/J4VP-L6D3] (acknowledging the difficulty in a quick disposal of shares for activists with board representation because of restrictions created by insider trading policies and SEC rules). *See generally* Matt Levine, *ValueAct Hedge Fund's Huge Microsoft Victory*, FORBES (Sep. 3, 2013), http://www.forbes.com/sites/nathanvardi/2013/09/03/valueact-hedge-funds-huge-microsoft-victory/ [perma.cc/P4E3-QS5G] (describing that the ValueAct's gaining of a board seat in Microsoft demonstrates the new power of activist investors in financial markets).

113. An investor that has designated a director to a public company's board may be subject to the short-swing trading rules in Section 16(b), which authorize an issuer to recover any profit realized by directors from a 'round-trip' purchase and sale (or sale and purchase) of an equity security within six months. *See* Blau v. Lehman, 368 U.S. 403, 409-10 (1962) (stating that an investor may be deemed a 'director' for Section 16(b) purposes if it deputizes a person to perform its duties on the board). For more discussion on Section 16(b), the rationale for this rule, and its impact, see Renée Sekino, *Second Circuit Holds That "Directors By Deputization" Qualify for Rule Exempting Certain Approved Transactions from Short-Swing Liability*, LITIG. (Milbank), Apr. 16, 2008, at 1-3, http://www.milbank.com/images/content/8/4/845/041608-Directors-by-Deputization.pdf [perma.cc/26EF-WV7Y]. *See also* Marc Weingarten & Neil P. Horne, *Be Careful What You Wish For — Considerations When Obtaining Board Representation*, ACTIVIST INVESTING DEVS. (Schulte Roth & Zabel), 2006, at 3, 5, http://www.srz.com/files/upload/Weingarten_BeCarefulWhatYouWishFor_AIDevelopments_Spring06.pdf [perma.cc/6YV6-U8YC] (explaining that if the designated investor appears to exercise control over the director, a court may find that the investor itself is a director for Section 16(b) purposes, whereas keeping the director's decision making independent of the investor could entirely avoid the investor's exposure to Section 16(b)). For further discussion on short-swing profit rules and types of circumstances under which "director by deputization" applies to a private equity fund, see also Carol Anne Huff & Elisabeth Martin, *Director Equity Awards to PE Fund Representatives on Public Company Boards*, INSIGHTS: THE CORPORATE & SEC. LAW ADVISOR 2, 3 (Sep. 2012), http://www.kirkland.com/siteFiles/Publications/Insights%20(Director%20Equity%20Awards_%20Huff%20byline).pdf [perma.cc/5SP3-2646].

114. Weingarten & Horne, *supra* note 113, at 3-4. *See* David M. Morris et al., *Designated Directors and Designating Investors: Early Planning Is Key*, INT'L LAW OFFICE (Jun. 16, 2008),

Fourth, having an unaffiliated nominee would, in cases of contested elections, makes it easier for the activist to convince other shareholders to support the activist ballot. By nominating an unaffiliated, impressive candidate, the activist can reassure shareholders that (1) such nominee would have the ability to act for the benefit of all shareholders and not just the activist, and (2) that an industry expert was convinced of the validity and favorable outcome of the activist's turnaround plan. The recent high profile case of Airgas/Air Products perfectly illustrates this point. Air Products, in its efforts to convince shareholders in its intentions, specifically stated in its press release that the three nominated directors were independent from both Airgas and Air Products and that these nominees would serve the shareholders as a whole (a statement that came true when these directors decided to reject Air Products' final bid).[115]

Finally, even in cases where a negotiated agreement with management is reached prior to the elections, many boards prefer that the activist itself would not sit on the board, particularly if the events prior to the agreement were not too amicable. In that respect, allowing the board to 'save face' and choose a candidate from a pre-determined list set by the activist, as is done in many cases,[116] could better facilitate the activist's long term plan for the company.

http://www.internationallawoffice.com/newsletters/Detail.aspx?g=13c8e903-9a06-4373-a39f-e485b73cc715#31 [perma.cc/8HRR-Y7PK] (describing various situations where conflicts arise amongst the interests of directors, investors, and corporations, and restrictions, such as those regarding voting and trading, that designated directors and investors face).

115. *See* Press Release, Air Prods. & Chems., Inc., *Air Prods. Notifies Airgas of Proxy Solicitation at 2010 Annual Meeting* (May 13, 2010), http://www.airproducts.com/company/news-center/2010/05/0513-air-products-notifies-airgas-of-proxy-solicitation-at-2010-annual-meeting.aspx [perma.cc/7Y2F-SHR2] (stating that the three nominees have notable qualifications and experiences that make them suitable for serving as independent Board directors and in the best interests of shareholders). For a more complete review of the case, *see* Steven M. Davidoff, *Case Study: Air Products v. Airgas and the Value of Strategic Judicial Decision-Making*, COLUM. BUS. L. REV. 502, 508 (2012), in which Air Products made a hostile offer to Airgas, whose directors announced a unanimous rejection of the offer that had excessively underestimated the value of Airgas.

116. *See* David E. Rosewater & Nicholas Tomasetti, *Proxy Contest Settlement Agreements: An Overview*, ACTIVIST INVESTING DEVS. (Schulte Roth & Zabel), 2009, at 1, http://www.srz.com/files/News/8f72fe1b-68bd-4b9a-b941-0959673ff622/Presentation/NewsAttachment/ee313e64-e311-42ca-ba25-04ddf3f859b0/AIDev_Winter09_Proxy.pdf [perma.cc/TW7S-PNHH] (discussing how the activist and company can benefit and save valuable resources through settlement agreements in early stages of proxy fights).

B. *The Frequent Need to Supplement Regular Director Pay*

Putting the benefits of unaffiliated directors aside, the question remains as to why activists should pay them handsomely on top of their regular board fees. However, finding people to serve as activist-nominated directors is not an easy task as one might think, which leads to the need to supplement pay.

From the activist perspective, the activist wants a nominee who is distinctively qualified, with a unique skill set that is suited for that specific company. Because the activist has a lot at stake, financially and as a matter of reputation, it is in the activist's interest to find a candidate that would bring value to the table, and in many cases, such value needs to exceed the value of the incumbent director. This makes the pool of candidates limited to begin with. That same stake in the game would lead the activist to look for candidates that not only possess the qualifications necessary for the job but that would also have the ability and desire to bring the activist's goals for the target company into fruition. This is not a trophy position to hold and enjoy, and as such, the pool of possible candidates who would be interested in it is significantly smaller.[117]

Similar challenges exist from the potential nominee's perspective. A qualified person with the skill set the activist seeks will have other options to consider. Even if such candidate is interested in the position as a general matter, if she accepts the invitation, she will need to learn the business well and go through a proxy fight, which she may lose (with the reputational and personal ramifications this might entail) and which may subject her to extreme scrutiny from the company and shareholders. Even if she wins the fight, she will still have to get on a board that did not, and might still not, want her. Additionally, she will have to try to convince the rest of the board to put in place changes that will generate shareholder value. Finally, such a candidate might harm her potential to sit on other boards as she will likely not be chosen by management of other companies to sit on their boards because she will be identified as an "activist-affiliated" director.

Indeed, the above gives merit to the argument that it may well be the case that standard director compensation is not enough to attract good candidates to a dissident slate.[118] Standard compensation is regularly set by

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117. To take the CNET example, JANA's nominees included Julius Genachowski (who later became the Chairman of the Federal Communications Commission) and Jon Miller (who later became Chief Digital Officer for News Corp). *See supra* note 46 and accompanying text (chronicling the JANA/CNET proxy fight).

118. *See* Laura Seery Cole, Designated Directors in the Boardroom: Their Impact on Governance and Performance and Shareholder Wealth Effects, 9 (Aug. 2011) (unpublished Ph.D. dissertation, University of Tennessee), http://trace.tennessee.edu/utk_graddiss/1068 [https://perma.cc/8QRS-KRPK] (discussing the high costs and dissuading effects that

boards based on assumptions of a collegial board and expectation of a steady stream of payments for a long duration (as the average board tenure is about nine years).[119] However, activist intervention, whether by itself or due to the underlying issues the target is facing, severely undermines these assumptions (for example, if the firm is sold). Board nominees, then, internalize these considerations into their pay expectations, asking for more money up-front to compensate for the greater risk of loss of future payments.

To illustrate this point: suppose X, a highly established individual, is approached by an activist who wishes to nominate X to its slate. X, knowing the activist's general time frame, expects to serve for three years on the board if elected and for an annual salary of $250,000 per year. This means a total of $750,000 if X is elected (which is not a sure thing). In return, X has to go through a proxy fight, attend board meetings as an outsider, and push hard for change. Many talented people can make this amount of money doing much more enjoyable things over a shorter period of time. Unless X is interested in the nomination for other reasons, the financial component of regular board compensation will probably not be a strong factor in convincing X to agree.

While some might argue that the fact that supplemental compensation is not offered in most cases is indicative of the lack of need for it, there are strong reasons to think otherwise. First, the fact that an activist was able to nominate a candidate without a pay package does not mean that this candidate was the optimal candidate, thereby effectively reducing the value the director would bring to the table. Second, some targets require an emphasis on management turnover, and thus do not require a specific board expertise. In these cases, having the activist or other 'standard' independent director could suffice. However, in cases where the change is expected to be driven at the board level, and where a specific 'star' nominee is required, supplemental pay might be the only way to go. Third, since activists incur high entry costs, and since reputation and connectedness play an important role in recruiting nominees, the fact that established activists, like Pershing Square, are able to recruit top candidates even without pay, does not mean that other activists can follow suit with the same success. Supplemental pay could then be a means to lower some of the entry barriers that these activists might face.

contentious elections have on potential directors).

119. *See supra* note 95 and accompanying text (noting data sources).

C. *Why Performance-Based Pay*

So far, I have argued that activists cannot, or should not, just appoint their own people to all of their various slates, but could rather benefit from utilizing the outside market for directors. I have also shown why some good candidates, who could help the company and in turn benefit shareholders, might not agree to be nominated if offered the regular pay package incumbent directors receive. However, even if supplemental pay is beneficial and needed in some instances, why should it be performance-based? Structuring director pay is a complex issue, but in the context of activist nominees there are several advantages to a performance-based pay.

First, performance-based pay provides activists with an effective screening function. Since the activist's outlook for the company is positive, supplemental compensation that is conditioned on the positive outlook coming to life allows the activist to recruit people who are similarly optimistic about their ability to make changes at the firm, as otherwise they would decline the position if in their estimation the activist's goals are unachievable.[120] Similarly, the willingness of these nominees to take the job, knowing that their pay is dependent on the activist's plan coming into life, serves as a screening tool to shareholders who can see if the activist were able to convince sophisticated players such as these nominees in its plan.

Second, performance-based compensation provides the activist with a signaling tool.[121] Since the activist has a positive outlook for the company, and the activist would like to convince its fellow shareholders of the sincerity of such belief, bringing board nominees that buy into this outlook and are incentivized to turn the positive outlook into a reality serves as a strong signaling tool to fellow shareholders.

Third, performance pay provides the activist with a risk-sharing

120. For a general review of screening theory, see Joseph E. Stiglitz, *The Theory of "Screening," Education, and the Distribution of Income*, 65 AM. ECON. REV. 283, 283 (1975).

121. For a discussion of signaling in the context of board structure, see S. Trevis Certo, *Influencing Initial Public Offering Investors with Prestige: Signaling with Board Structures*, 28 ACAD. MGMT. REV. 432, 434-39 (2003). For a general review of signaling theory, see Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355, 355-56 (1973). In the VC context, signaling plays an important role. *See, e.g.*, Christian Hopp & Christian Lukas, *A Signaling Perspective on Partner Selection in Venture Capital Syndicates*, 38 ENTREPRENEURSHIP THEORY & PRAC. 635 (2014) (analyzing the factors impacting partnering decisions in VC syndicates from a signaling perspective using VC transactions in Germany); Steven N. Kaplan & Per Strömberg, *Characteristics, Contracts, and Actions: Evidence from Venture Capitalist Analyses*, 59 J. FIN. 2177, 2200 (2004) (noting that ex ante staging using explicit milestones is a way for VCs to screen out bad firms because it signals internal risks).

element. The activist is bearing significant risks in any engagements with target companies. While the costs of an engagement with the target are certain, the rewards are far from it. The activist has to incur various costs throughout the process, from investing in research, the costs of engagements, and equity costs (including alternative investment costs), but the success of its fight with incumbents, and the potential rewards, is not guaranteed. Even if the activist wins the fight with management, its turnaround plan, as sound and promising as it may be, might not work out. So, while the activist is willing to incur up-front out-of-pocket costs to turn around a company in a way that is expected to generate positive externalities for other shareholders, the activist does not want to pay more than it has to. Performance-based pay reduces the downside costs, as the nominees will only get paid if things work out as planned.

Finally, and possibly most importantly, performance-based pay, if structured correctly, is beneficial on its own merits, as it will provide the nominee with enhanced motivation to work hard and to achieve the performance thresholds that would benefit the company as a whole.[122] The benefits of performance-based compensation in incentivizing employees to invest efficient resources have been greatly detailed in academic literature[123] and are just as relevant in the case of directors.

D. *The Benefits of Activism Enhanced with Supplemental Pay*

While activism, or the threat of it, is already beneficial, there are strong reasons to believe that supplemental pay would enhance these

122. For a review of the benefits of incentivized pay, see generally LUCIAN A. BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2009).

123. The literature on executive pay and pay for performance benefits is vast. *See* Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 17 J. APPL. CORP. FIN. 8, 12-17 (2005) (demonstrating that the pay-setting process in U.S. public companies does not follow the arm's-length model and highlighting potential ways to better align manager and shareholder interests through pay arrangements); *see also* Todd A. Gormley et al., *CEO Compensation and Corporate Risk: Evidence from a Natural Experiment*, 56 J. ACCT. & ECON. 79, 154 (2013) (confirming empirically the relationship between the structure of managerial compensation and corporate responses to risk); Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 227 (1990) (estimating the change in CEO wealth relative to the change in shareholder wealth); Steven N. Kaplan, *Executive Compensation and Corporate Governance in the United States: Perceptions, Facts, and Challenges*, 2 CATO PAPERS ON PUB. POL'Y 99 (2012) (challenging the common perceptions that CEOs are overpaid and are neither paid for their performance nor penalized for poor performance); Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, 2 HANDBOOK ECON. FIN. 211, 213 (2013) (documenting the current state, history, and international comparisons of CEO pay as institutional context to help formulate a general theory).

benefits. The ability to attract top-flight candidates to an activist slate would have positive impacts on both companies that are targeted by the activist and those that are not. First, since attracting better candidates would improve the activist's chances to win a potential proxy fight, this would serve as a more effective deterrent tool ex-ante, making management more accountable to shareholders, since management would know that the chances of a successful bid are higher. Second, when an activist does launch a proxy fight, the outcome would be better for shareholders of the target. On the one hand, since management would take the risk more seriously, it is likely to take action that would benefit shareholders. On the other hand, if these nominees are elected, they would be better equipped and better incentivized to improve shareholder value. Third, to the extent supplemental pay would allow activists to engage with more companies, both the effectiveness of the ex-ante deterrence effect and the actual improvement to targets ex-post would be enhanced.

IV. OBJECTIONS TO ACTIVIST PAID-DIRECTORS

So far, the benefits stemming from the appointment of non-affiliated directors and providing them with performance-based supplemental pay were detailed. This Article now turns to identify, and respond to, three common objections to activist-paid directors: (1) they lack independence; (2) they will reduce board cohesion; and (3) they will cause the firm to be too short-term oriented.[124]

124. In a memo issued by the firm Wachtell, Lipton, Rosen & Katz, Martin Lipton and fellow attorneys summarized their objection to outside director pay, stating that it would undermine "[b]oard prerogatives to set director pay," would create "a multi-tiered, dysfunctional Board in which a subset of directors are compensated and motivated significantly differently from other directors," would create "economic incentives to take the corporation in the specified direction, and within the timeframe, that would trigger outsized compensation, whether or not doing so would be in the best interests of all shareholders, would engender inappropriate and excessive risk, or would sacrifice long-term value for short-term gain," would open "a schism between the personal interests of directors who stand to benefit in the short-term from the special compensation scheme and the interests of shareholders with a longer-term investment horizon," would create "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" and would introduce "unnecessary and problematic complexity and conflicts in strategic reviews and calling into question those directors' ability to satisfy their fiduciary duties." Martin Lipton et al., *Bylaw Protection against Dissident Director Conflict/Enrichment Schemes*, SHAREHOLDER ACTIVISM UPDATE (May 9, 2013), http://www.scribd.com/embeds/140691513/content?start_page=1&view_mode=scroll [perma.cc/E57T-58KS]. For a detailed review of the general arguments against activists and a response, see Bebchuk 2013, *supra* note 24.

A. *Lack of "Independence"*

In a widely held public company, it is important that directors be independent of those controlling the firm's day to day operations—the managers—who have interests that at times might be adverse to those of shareholders.[125] However, while director independence is important, it is necessary to identify from whom directors need to be independent. In the context of the U.S. widely held public firm, it is not important that directors be independent of shareholders as a group;[126] in fact, such independence would be undesirable, since the directors are elected by the shareholders to promote their interests.

Wachtell, and other opponents of these pay arrangements, have argued that 'golden leashes' prevent dissident directors from being 'independent.' This Article addresses this line of opposition and explains that activist-paid directors are (i) independent of the activists, and (ii) even if they were dependent on the activists, they would be no more dependent on a particular shareholder than directors in other settings. Finally, I argue that no harm would flow if these activist non-affiliated directors were in fact dependent on the activists.

1. Activist-Paid Directors Are Independent of the Activists

While initial instinct might lead one to think that supplemental pay to activist-nominees makes such nominees dependent on the activist, a closer examination reveals that the opposite is true. It is the payment to the nominee, particularly if given in the form of performance-based pay that actually decouples the nominee and the activist's interests, in cases where

125. For the structure of the U.S. firm and the agency problem it entails, see ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Macmillan Co. 1932); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983). For the role of the board in mitigating this issue, see, for example, MELVIN EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 139–41 (Beard Books, 1976); Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1471 (2007). *See also* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 155 (Oxford Univ. Press, 2008) (detailing the emergence of the monitoring structure over the last few decades).

126. In a controlling shareholder situation, it becomes important that some directors will be independent from the controlling shareholder, as the agency concern shifts from managers vs. shareholders concern to minority shareholders vs. controlling shareholder concern. *See, e.g.*, Kobi Kastiel, *Executive Compensation in Controlled Companies*, 90 IND. L.J. 1131, 1144 (2015) (arguing that controlling shareholders tend to overpay managers by expropriating funds from minority shareholders to maximize their private benefits due to their close social and business ties with managers).

the benefit of the company and the benefit of the activist diverge. The compensation structure is set prior to the nominee's election in what might be called a 'fire and forget' compensation package, which is not retrievable by the activist post-election. And since such compensation is dependent on the company's performance and not the activist's performance, the nominee is actually incentivized to be independent of the activist in cases where the company and the activist's interest diverge. If the activist's interests are for the company to adopt policy X, since it will improve its value in other holdings but it will come at the expense of the profits of the company, it will be in the best interest of the director to ignore the activist's plan and adopt policy Y that would maximize the firm value and hence the director's own pay.

Of course, some will contend that even if it is in the activist-nominee's best interest to maximize the company's value in the short term, the nominee will approach it as a repeat-player, looking at the impact such decision will have on its long-term prospects. In particular, the nominee would know that the activist won't use her next time if the director acts independently; thus, the director will sacrifice the short term goals to maximize its long term prospects, the argument goes. However, this argument is not persuasive on several fronts. First, the type of activist-nominees that receives the supplemental pay are people that typically have ample other opportunities, which is why such compensation was needed to begin with, and, unlike professional directors they are not hoping to make a good living by getting appointed by CEOs to public company boards. This casts doubt that the nominee will approach her position as a repeat-game scenario. Second, to the extent the pay package is sufficiently large, the director is likely to focus on maximizing her pay in the current position, even if she knows that would reduce her likelihood to be appointed again. Third, most of these activist-nominees possess specific attributes that are germane to the specific company the activist is targeting. Since most activists target a variety of companies (where most of them will not suit the activist-nominee skill set), and launch a very small number of proxy fights each year, the likelihood of being reappointed by the same activist is not high to begin with,[127] making the repeat-player concern more of a hypothetical argument.

Even if we accept the contention that the pay given to activist-nominees creates some level of dependence, behavioral or rational,[128] the

127. Activist hedge funds rarely appoint the same "outside nominees" to multiple companies for other reasons (specialty, independence), which makes this an even more remote concern.

128. *See* J. Robert Brown Jr., *The Myth of Director Independence Under Delaware Law: The Payment of $376,733 Does Not Result in a Loss of Director Independence*,

fact of the matter is that these activist-nominees are just as independent as, if not more independent than, the "regular" so-called independent directors, who owe their seat to, and feel loyal to, the CEO.[129] In that respect, one should ask whether we should be more concerned with independence from management or from a shareholder. Since shareholders most often share the same goal, having a director more concerned with shareholders' needs, even if focused on a particular shareholder, would likely be the better outcome than if such director preferred the needs of management, to whom the director was beholden. Finally, even looking at the monetary dependence of the directors, it is not clear that the supplemental pay poses a greater issue than the regular pay, and other perks directors receive, which these directors wish to maintain for a longer duration. There are many cases where incumbent directors are showered with perks and cash in exchange for giving CEOs generous compensation packages.[130]

2. Activist-Paid Directors are More Independent than Activists themselves

Even in the specific case of activist nominees, non-affiliated director independence is actually the easier scenario. In many engagements of activists with target companies, the activists themselves are elected as board members, either via election as part of a proxy fight or as part of a negotiated standstill agreement. For instance, Mr. Ackman, the head of Pershing Square Capital Management, and Steven Roth, the chairman of Vornado Realty Trust, were appointed as independent board members of J.C. Penney, months after the two investors disclosed major stakes in the company.[131] Similarly, ValueAct President G. Mason Morfit joined

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THERACETOTHEBOTTOM.ORG (Apr. 25, 2011, 6:00 AM) http://www.theracetothebottom.org/independent-directors/the-myth-of-director-independence-under-delaware-law-the-pay.html [perma.cc/Q5VX-AJJX] ("[T]reating at least some of these directors as guardians of the interests of shareholders is at best misguided and at worst misleading."). For an examination of the regulatory landscape, 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, 399–403 (2005), which details Delaware and federal treatment of fees.

129. *See* BEBCHUK & FRIED, *supra* note 122 (noting that under the official model of executive compensation, executives have control over their own pay whether the directors are independent or not).

130. *See* Ichan, *supra* note 70 (describing mutually beneficial arrangements between boards and management that provided perks to non-employee directors such as "private planes, box seats at premier sporting events, country club memberships, re-pricing of underwater stock options, tax gross-ups and . . . massive cash payments," while CEOs made 1,000 times the wages of the average worker).

131. *See* Michael J. de la Merced, *2 Big Investors Get Their Say at J.C. Penney*, N.Y.

Microsoft's board of directors in 2014 after the hedge fund took a $2 billion position in the company.[132] These directors, often the heads of the activist in flesh and blood, are treated by the company, and by stock exchanges rules, as independent board members despite being the shareholder itself and not a mere paid third party.

3. There Are Many Similar Arrangements Throughout Corporate America Where Directors Are Generally Considered Independent Even Though They Are Less Independent Than Activist-Paid Directors

While supplemental pay packages and high-profile activists may attract a higher level of initial concern regarding the activist-nominees and their independence, in reality there are numerous cases throughout the U.S. public market's landscape where directors with more significant ties to shareholders are considered independent.

Controlling shareholder

First, many public companies have a controlling shareholder.[133] In these companies the controlling shareholder has direct influence on the board's composition, and the board members may be directors who have financial and social ties to the controller. Despite these significant ties, Delaware courts have provided such directors with a presumption of independence, stating, "[m]erely because a director is nominated and elected by a large or controlling stockholder does not mean that he is necessarily beholden to his initial sponsor."[134] More so, Delaware courts have refused to recognize the nomination power of a controlling

TIMES DEALBOOK (Jan. 24, 2011, 8:51 PM), http://dealbook.nytimes.com/2011/01/24/2-big-investors-get-their-say-at-j-c-penney/?_php=true&_type=blogs&_r=0 [perma.cc/G88C-ECEJ] (documenting the process through which Ackerman and Roth joined J.C. Penney's board).

132. *See* Vardi, *supra* note 34 (reporting on how ValueAct forcing its way onto Microsoft's board despite owning only 0.8% of Microsoft).

133. *See generally* Kastiel, *supra* note 126 (discussing the role of controlling shareholders and their relationship with management).

134. Frank v. Elgamal, 2014 Del. Ch. LEXIS 37, at *70 (Del. Ch. Mar. 10, 2014); *see also* Kahn v. M&F Worldwide Corp., 88 A.3d 635, 648-49 (Del. 2014) ("To show that a director is not independent, a plaintiff must demonstrate that the director is 'beholden' to the controlling party 'or so under [the controller's] influence that [the director's] discretion would be sterilized.'") (quoting Rales v. Blasband, 634 A.2d 805, 936 (Del. 1993)). Thus, to establish a lack of independence in the context of controlled company, a plaintiff meets his burden by showing that the directors are either beholden to the controlling shareholder or so under its influence that their discretion is sterilized.

shareholder as refuting the presumption of independence,[135] declaring that the fact that a company's executive chairman or a large shareholder played some role in the nomination process shall not, without additional evidence, automatically foreclose a director's potential independence.[136] Accordingly, Delaware courts have declared that the fact that a 47 percent stockholder personally selected all of the directors of the corporation was not sufficient to establish that the stockholder dominated and controlled the corporation's board of directors.[137]

Specifically in the context of financial payments, and consistent with the overarching requirement that any disqualifying tie would be material, the simple fact that there are some financial ties between the interested party and the director is not disqualifying under Delaware law. Rather, the question is whether those ties are material, in the sense that the alleged ties could have affected the impartiality of the director.[138] Wachtell, the law firm leading the charge against supplemental pay to activist-nominees, actually applauded[139] this decision, even though the court concluded that

135. *See* Khanna v. McMinn, 2006 Del. Ch. LEXIS 86, at *57 (Del. Ch. May 9, 2006) ("'Directors must be nominated and elected to the board in one fashion or another' and to hold otherwise would unnecessarily subject the independence of many corporate directors to doubt.") (quoting In re W. Nat'l Corp. S'holders Litig., 2000 Del. Ch. LEXIS 82 (Del. Ch. May 22, 2000)).

136. *See* In re W. Nat'l Corp. S'holders Litig., 2000 Del. Ch. LEXIS 82, at *54 (Del. Ch. May 22, 2000) ("Although independent nominating committees may indeed have a salutary effect on board efficacy and independence, and are surely a 'best practice' which the corporate governance community endorses, they are not a sine qua non for director independence under Delaware law.")

137. *See* Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984) (holding that the fact that an individual owned 47% of a company's stock and personally selected the directors did not mean the directors were not independent); *see also* Andreae v. Andreae, 1992 Del. Ch. LEXIS 44, at *10 (Del. Ch. Mar. 3 1992) (noting that Delaware courts have consistently rejected the notion that a director cannot act independently of the entity that appointed him or her to the board).

138. *See* In re MFW S'holders Litig., 67 A.3d 496, 509-13 (Del. Ch. 2013) (stating that financial ties are to be examined through the context of their meaning for both the shareholder and the director, that a $100,000 fee was not deemed to affect the independence of such director, and that "[the] plaintiffs have not put forth any evidence that tends to show that the $200,000 fee paid to Dinh's firm was material to Dinh personally, given his roles at both Georgetown and Bancroft"); *see also* In re Freeport-McMoran Sulphur, Inc. S'holders Litig., 2001 WL 50203, at *4-5 (Del. Ch. Jan. 11, 2001) (finding that a consulting fee of $230,000, increased to $330,000 after the merger, did not cast doubt on a director's independence, where the plaintiffs had not alleged that the fee was material to the director); In re Walt Disney Co. Deriv. Litig., 731 A.2d 342, 360 (Del. Ch. 1998), *aff'd in part, rev'd in part on other grounds sub nom.*; Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (finding that legal and consulting fees of $175,000 paid by Disney to Senator George Mitchell and his law firm did not cast doubt on his independence, where the plaintiffs had not alleged that the fees were material to Mitchell).

139. Theodore N. Mirivs et al., *Wachtell on Controlling Shareholders and the Business*

the three directors were independent despite the financial fees they received from the controlling shareholder.

"Constituency" Directors

"Constituency" directors, i.e., directors who have ties to a major shareholder, investor or other interested party are extremely prevalent in the U.S. The practice of awarding board representation to significant shareholders, V.C. firms and other interested stakeholders is not new and is commonplace in many of the major corporations in the U.S. For instance Berkshire Hathaway, who is a major shareholder in Coca-Cola Company, has Howard G. Buffett, Warren Buffet's son, as an independent director on Coca-Cola's board.[140] Similarly, Venture Capital firms often have their partners sit on boards of public companies that they have backed through the IPO process,[141] while they still hold an equity portion (at times very significant) in the corporation. These VC appointed directors are considered independent even though the VC firms appoint them and in many cases the directors are partners in the VC firms themselves. For instance, Castlight Health, which went public in March 2013 and has a market cap of $1.26B, has five "independent" VC partners on its board.[142] Twitter has a partner of a VC firm that holds 5.35% of its shares on its board.[143] Similar VC representation can be found in many of the recent large VC-backed IPOs such as: Zulily, Yelp, A10 Networks, Tableau Software and FireEye Inc.[144] If a concern truly exists regarding the independence of board members who were appointed by shareholders, cases where the nominees are the shareholders themselves, particularly in the case of VC firms on the verge of exit, should be at the top of the list.

Judgment Rule in Going Private Merger Transactions, THE CLS BLUE SKY BLOG (Jun. 3, 2013), http://clsbluesky.law.columbia.edu/2013/06/03/wachtell-discusses-court-of-chancerys-application-of-the-business-judgment-rule-to-controlling-stockholder-mergers/ [perma.cc/B8NF-2B9J].

140. *Board of Directors: Howard G. Buffett*, COCA-COLA, http://www.coca-colacompany.com/our-company/board-of-directors-howard-g-buffett/ [perma.cc/3NYB-A7AU] (last visited Dec. 18, 2015).

141. *See* Brian Broughman and Jesse Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-backed Firms*, 95 J. OF FIN. ECON 384, 386 (2010) (showing that similar representation can be found in private companies with VC Directors).

142. Dr. Bryan E. Roberts (Chairman) and Dr. Robert (Bob) Kocher from Venrock (20% SH); Ann (Annie) Huntress Lamont from Oak Investment Partners LP (12% SH); Christopher (Chris) P. Michel from Nautilus Ventures LLC; and David B. Singer from Maverick Capital Ltd. (P). *See* data on file with author (containing information about venture capital representation on boards of directors).

143. *Id*.

144. *Id*.

4. And If Not Functionally Independent from the Activist, So What?

Even if we assume that there is some dependency when activists nominate and pay their nominees, that these directors are not functionally independent from the activist, and we, despite the prevailing law and stock exchange regulations,[145] would like to treat these directors as non-independent directors (despite them being considered independent by the letter of the law), a compelling case can be made that these classifications as independent/non-independent would change nothing in the way shareholder interests, and the company interests, are protected.

First, since in these cases of paid activist-nominees the concerns raised are not regarding potential deals that are not at arms-length with the activist or any other side deals with the activist, but rather regarding the direction of the company, the independence of these directors from the activist should not matter. Of course, in cases in which side deals are involved, current laws[146] would probably prohibit these directors from voting anyway.

Second, and more importantly, these activist-nominees often constitute the minority of the board, as in most proxy fights the activist's slate is a short one, attempting to gain some presence on the board, but not total control.[147] As a minority, even if we assume the worst of intentions, these directors would still need to convince enough of their peers to gain majority. Assuming the actions that concern Wachtell and others, are ones that allegedly clearly benefit the activist and are at the expense of the firm and other shareholders, such persuasion would be extremely unlikely.

Third, if the concern of the opponents of supplemental pay is that the

145. *See* NYSE LISTED COMPANY MANUAL, § 303A (2012), http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp%5F1%5F4&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F [perma.cc/7DNK-UUS5] (reciting the NYSE rules related to corporate governance standards, including director independence); *see also* Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards* (UCLA Sch. of Law, Research Paper No. 02-15, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=317121 [perma.cc/975G-AMV9] (critiquing the NYSE standards provisions related to director independence).

146. Since the directors would stand to gain directly from these deals, they would be considered non-independent for these matters. *See supra* note 134 (discussing what is generally necessary to demonstrate a lack of independence in a controlled company).

147. However, in some instances the activist does try to gain total control. *See, e.g.*, *Jana Offers Its Plan to Help Revive CNET*, *supra* note 46 (showing activists trying to gain control of a board). In a recent development activist hedge fund Pershing Square went even further, joining forces with a strategic buyer in an attempt to take over Allergan. Brian Solomon, *Billionaire Bill Ackman, Valeant Want To Take Over Botox-Maker Allergan,* FORBES (Apr. 21, 2014), http://www.forbes.com/sites/briansolomon/2014/04/21/billionaire-bill-ackman-valeant-want-to-takeover-botox-maker-allergan/ [perma.cc/LKF2-KGG7].

activist-nominees are financially tied to the activist even after they are elected,[148] then this concern could be easily removed in future engagements. Since the activist's relationship with its nominee is contractual and since the payment is made in cash and not in stock or equity in the activist, it is simple enough for the activist to insert an assumption provision in the agreement allowing the company to assume such payment if the nominee is elected. This would give shareholders a choice both as to whether they think the nominee is better qualified than the incumbent directors as well as to whether there is a concern of independence that merits the assumption of the payment by the company.

Finally, Delaware law, with its well-developed framework of fiduciary law, similarly reduces the concern that an activist-paid director would harm shareholders even if not truly independent of the activist. Delaware law has long lasting framework that deals with directors whose independence from a shareholder might be in question. The basic framework of Delaware law is that all directors owe their fiduciary duty to the corporation and to shareholders as a whole and that failure to do so would represent a breach of their duty of care or duty of loyalty,[149] as the duty of designated directors is to the corporation and its stockholders, not to the particular designator.[150] While the question of what would amount to a breach of a duty in such cases is often murky,[151] and director's actual risk

148. It is important to note that all activist nominees have been long receiving a front sum of $50,000 for their trouble–this has not raised the outcry of the opponents of supplemental pay. *See Activist Investing*, *supra* note 42 (noting the prevalence of supplemental pay for activist nominees).

149. *See, e.g.*, Williamson v. Cox Commc'n, 2006 WL 1586375, at *4 n.49 (Del. Ch. June 5, 2006) ("[A]s directors. . . the individual defendants owed fiduciary duties to the company"); FRANKLIN BALOTTI & JOSEPH FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, § 4.16[E][2] (3d ed. 2003 & Supp. 2008) ("The duties of directors designated by large stockholders are clear: under *Weinberger*, they still owe the corporation and its shareholders 'an uncompromising duty of loyalty'"); EDWARD P. WELCH, ANDREW TUREZYN & ROBERT S. SAUNDERS, FOLK ON THE DELAWARE GENERAL CORPORATION LAW, § 141.2.1.7 (5d ed. 2013) ("[T]he law does not recognize a special duty on the part of directors elected by a special class to the class electing them. Rather, the law demands directors' fidelity toward the corporation and all its shareholders."). *See generally* Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761 (2008) (asserting existing standards of liability for breach of fiduciary duty are sufficient to account for directors who seemingly represent a particular constituency of a corporation).

150. *See* BALOTTI & FINKELSTEIN, *supra* note 149, at § 4.38(B) (noting that the duty of designated directors lies with the corporation).

151. *See* Cyril Moscow, *Corporate Governance: The Representative Director Problem*, 16 INSIGHTS no. 6, 12, 12 (June 2002), http://www.honigman.com/media/site_files/456_imgimgMoscow.pdf [perma.cc/KR4D-AZW5] (indicating that the dearth of case law and literature addressing the unique position

of liability might be called into question,[152] it is nevertheless a factor that could curb the risk of sacrificing shareholder interests to the benefit of the activist.

Ironically, Wachtell, who now loudly criticizes the independence of activist-paid directors and their ability to serve all shareholders, has been a vocal advocate of directors' ability to serve all shareholders and the effectiveness of their fiduciary duties in other contexts, particularly when their independence from management, rather than an activist, was questioned.[153] If Wachtell truly believes that "public company directors are acutely aware of their fiduciary duties, to shareholders and others, and work hard to meet them[,]"[154] then it should not matter if the concern is their independence from management or from an activist shareholder.

B. *Reduced Board "Cohesiveness"*

Critics often claim that activist-paid directors will make boards less cohesive.[155] The loss of "cohesiveness" and fragmentation of the board

of representative directors can result in the "unnecessary separation of legal doctrine from corporate activity that can create confusion, expense and possible liability").

152. *See generally* Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006) (discussing the limited personal liability exposure outside directors face).

153. *See* Lipton & Savitt, *supra* note 24, at 751 ("[T]o the contrary, our experience indicates that public company directors are acutely aware of their fiduciary duties, to shareholders and others, and work hard to meet them. Moreover, to the extent directors can be shown to 'divert corporate resources' or resist 'value-increasing changes,' they would clearly be subject to liability under current law.").

154. *Id*.

155. *See* Lipton et al., *supra* note 124, at 1 (asserting that the special compensation arrangements offered by activist investors threaten by misaligning the ultimate interests of activist-paid directors, those of the other directors, and those of the shareholder). A close-knit board could be beneficial by increasing trust and openness between board members. *See* John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board To Meet New Governance Mandates*, 59 BUS. LAW. 421, 445–46 (2004) (suggesting that shared interests promote honest dialogue and constructive criticism within a group); James D. Westpahl & Edward J. Zajac, *Defections from the Inner Circle: Social Exchange, Reciprocity and the Diffusion of Board Independence in U.S. Corporations*, 42 ADMIN. SCI. Q. 161, 163–64 (1997) (citing social psychological research that demonstrates high levels of group cohesion facilitate cooperative behavior among group members). However, these benefits do come with a price tag of decreased independence and of increased difficulty in impartially assessing another director's work. *See* Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 612-13 (1982) (indicating that independent directors are not required to forgo social friendships, or even membership, in the group whose actions they are asked to assess); Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1256-57 (2003) (suggesting that groups create a shared perception, which may not be accurate, simply because some members in the group possesses a particular view). Moreover, a close-knit board could create a tendency to avoid conflict, even when conflict may yield beneficial

would damage the board's effectiveness, the argument goes. Nonetheless, even if true, the introduction of activist-paid directors might be a good thing, as activists most often target firms that perform poorly,[156] where the problem is more likely to be that the board is too cohesive, preventing it from being effective and from taking the hard steps necessary to improve firm performance.[157] Second, even in cases where activist intervention is in the better-performing companies or in well-functioning boards, studies have shown that lack of cohesiveness might actually contribute to company and board performance.[158] Third, supplemental pay might actually serve as a way to smooth the financial interests between the incoming directors and the more tenured directors. Specifically, front-loading the financial interests of the activist nominees is more likely to bring them closer to the financial interests of the rest of the board, and not the other way around.

strategic changes, if such action would undermine the friendship one has formed. *See* Karen A. Jehn & Priti Pradhan Shah, *Interpersonal Relationships and Task Performance: An Examination of Mediating Processes in Friendship and Acquaintance Groups*, 72 J. PERSONALITY & SOC. PSYCHOL. 775, 786 (1997) (examining behavior in different groups); Janine Nahapiet & Sumantra Ghoshal, *Social Capital, Intellectual Capital, and the Organizational Advantage*, 23 ACAD. MGMT. REV. 242, 244-45 (1998) (identifying that the social capital inherent in friendships and obligations encourages cooperative behavior but reduces confrontation); Reed E. Nelson, *The Strength of Strong Ties: Social Networks and Intergroup Conflict in Organizations*, 32 ACAD. MGMT. J. 377, 396-97 (1989) (finding generally that strong ties between groups are typical in low-conflict organizations). *See also* Jerry Goodstein & Warren Boeker, *Turbulence at the Top: A New Perspective on Governance Structure Changes and Strategic Change*, 34 ACAD. MGMT. J. 306, 313 (1991) (suggesting that the longer the members of a board of directors have worked together, the more likely they are to resist change).

156. A SharkRepellent study shows that underperformers are three times more likely than outperformers to be targeted by activists. *See* Adam Kommel, *SharkRepellent study shows underperformers three times more likely to be targeted by activists than outperformers*, SHARKREPELLENT.NET (Dec. 16, 2013), https://www.sharkrepellent.net/request?an=dt.getPage&st=undefined&pg=/pub/rs_20131216.html&rnd=975479 [perma.cc/6ZMS-9UA8] (finding that out of the 1,123 activist targets in the study, 70.3% underperformed the Russell 3000 by at least ten percentage points whereas only 21.5% of activist targets outperformed by more than ten percentage points).

157. *See* Charles J. Cuny & Eli Talmor, *A Theory of Private Equity Turnarounds*, 13 J. CORP. FIN. 629, 638 (2007) (discussing the hurdles that the corporation might encounter during an internal effort to enact a turnaround and finding that under board process, the board may be unable or unwilling to recognize its own failings).

158. *See supra* note 155 and accompanying text (examining board cohesiveness). *See also* Khaled Elsayed, *Board Size and Corporate Performance: The Missing Role of Board Leadership Structure*, 15 J. MGMT. & GOVERNANCE 415, 423 (2011) (discussing the impact CEO-Chairman duality has on board effectiveness and how cohesiveness can cause independent directors to exit the game of monitoring altogether); Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-making Groups*, 24 ACAD. OF MGMT. REV. 489, 496 (1999) (suggesting that very high levels of cohesiveness are likely to prove detrimental to the quality of the board's decision making).

Thus, to the extent financial stake has an impact on cohesiveness, supplemental pay actually serves as a smoothing factor rather than diverging one.

Fourth, and most importantly, the argument that paid activist-nominees will reduce board cohesiveness assumes that such cohesiveness already exists on companies' boards, and that the cohesiveness is dependent on the directors being elected as part of one slate and with similar financial incentives. In reality, however, these assumptions are far from portraying an accurate representation of how boards are comprised.

1. Boards Already Have Shareholder-Affiliated/Nominated Directors

A fundamental part of the above-mentioned argument regarding board cohesiveness is the underlying claim that boards already possess a cohesiveness stemming from their election as one unit, organized by the company to produce a 'whole is greater than the sum of its parts' structure. That claim, while appealing on its face, portrays a reality that is no longer accurate, or that may very well never have existed in many companies.

As detailed above, "constituency" directors, i.e., directors who have ties to a major shareholder, investor, or other interested party, are extremely prevalent in the U.S.[159] The practice of awarding board representation to significant shareholders, venture capital firms and other interested stakeholders is not new and is commonplace in many of the major corporations in the U.S. Activist investors often demand, and receive, board representation in their companies as part of an agreement with incumbent management. Similarly, venture capital firms often have their partners sit on boards of public companies they have backed through the IPO process while they still hold equity portions (at times, very significant ones) in the corporation. Private equity firms have similarly sought board representation in their public holdings. Finally, controlled companies present another example of a board that may contain different factions of members with diverging interests, as the controlling shareholder may appoint the majority of directors while minority shareholders are still able to gain board representation through cumulative voting, or otherwise.

In sum, while many companies have a board that is fully supported by management, many other companies have a board composition that does not follow the narrative of the pre-designed cohesive board composition. Moreover, the assumption that board cohesiveness is dependent on the circumstances by which a director earned her seat, rather than on her social

159. *See supra* notes 141-144 and accompanying text (discussing venture capital representation on boards of directors).

and professional background, merits more intense scrutiny.[160]

2. Even Management-Nominated, Non Shareholder-Affiliated Directors Have Diverse Interests

A second weakness in the argument that board cohesiveness would be thwarted by the insertion of financial motives into the boardroom in the form of activist-affiliated nominees with supplemental pay is that a variety of different motives, financial and others, already exist in the boardroom even without the activist nominees. In that sense, to the extent board cohesiveness exists and is important to the function of the board,[161] the insertion of an additional set of financial motivations of an activist nominee should not change much. As this Article further details below, the attempt to pigeon-hole board cohesiveness into stemming from the fixed compensation granted by the company or from its election as one unit seems to disregard the inherent diversity of the board itself. Not all directors are created equal, even without the activists' presence. Some directors are more tenured than others, some are employees while others are not, and some serve on other boards while some do not.

Director Tenure

Almost every company's board has some variance in its members' tenure.[162] Some directors have served for many years on the board while others were just recently appointed. Some directors expect to retire soon while others are hoping to stay for many more years. No board is identical to each other and no board stays the same over time. The variance in tenure, important in and of itself,[163] has a direct impact on director motives.

160. *See generally* Forbes & Milliken, *supra* note 158 (underscoring the need for further research on the link between board demographics, group dynamics, and corporate performance). For a detailed analysis of group dynamics, what drives board effectiveness and what is important in board cohesiveness, see C. B. Ingley & N.T. van der Walt, *Board Configuration: Building Better Boards*, 3 CORP. GOVERNANCE 5, 8 (2003), which cites intra-board dynamics, constituency concentration, and diversity as relevant factors.

161. *See* Forbes & Milliken, *supra* note 158, at 496 (identifying a curvilinear relationship between board cohesiveness and board task performance).

162. *See* 2010 SPENCER STUART BOARD INDEX, *supra* note 95, at 16 and accompanying text regarding board tenure (identifying, for example, an average tenure length of 8.5 years but noting that 62% of boards have an average tenure between six and ten years and that 21% of boards have an average tenure of eleven or more years).

163. *See* Judy Canavan et al., *Board Tenure: How Long is Too Long?* 28 DIRECTORS & BOARDS-AM. EDITION 39, 41 (2004) (suggesting that long tenure can serve as a bottleneck on the mix of director talent and performance); Nikos Vafeas, *Length of Board Tenure and Outside Director Independence*, 30 J. BUS. FIN. & ACCT. 1043, 1062 (2003) (linking outside director tenure with variations in outside director affiliation, equity, reputation, and power

Some directors, with long tenure, tend to have a lot of stock in the company, while other directors are just starting to accumulate equity in the company. Those directors who intend to retire soon might prefer to liquidate their position and exit; others are new on board and want to serve many years, and thus may be less sensitive to short term changes in share price but more sensitive to actions that might endanger their ability to serve on the board in the long-term.

Insiders vs. Outsiders

Even if we assume that all of the directors have the same tenure and similar expectations, the board itself, by practice and by regulation, is still divided into two factions: the "insiders" and the "outsiders." Most, if not all boards, have at least one company employee on the board, the CEO, and many companies have several other high-ranking employees on the board.[164] The board members that are also employees of the company are considered "insiders," as opposed to the independent directors that all public companies boards must also have.[165] By virtue of being a company employee, the group of inside directors holds significantly differing motives than its independent counterpart. As company employees, these directors stand to lose much more if certain changes to the company were to be taken, as their human capital is much less diversified (their employment), and the benefits they can extract from it might be at risk.[166] Additionally, employee-directors' equity in the company is also significantly higher and different from the rest of the board as the employee-directors have both director compensation and executive

as being affected by varying tenure lengths of outside directors); Sterling Huang, Zombie Boards: Board Tenure and Firm Performance 19 (July 29, 2013) (unpublished seminar paper, Singapore Management University – School of Accountancy) (on file with INSEAD Business School) (identifying board tenure effects on a firm's M&A performance, financial reporting quality, compensation practices, CEO replacement decisions, and changes in strategic direction).

164. According to a 2013 report, 40% of the S&P 500 had at least one additional employee, besides the CEO, on their respective boards. *Cf.* 2013 SPENCER STUART BOARD INDEX, *supra* note 95, at 12 ("On 60% of boards today, the CEO is the only non-independent director. . . .").

165. *See* Standards Relating to Listed Audit Committees, 68 Fed. Reg. 18,788, 18,789-90 (April 16, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, and 274) (requiring the independence of each member of public company audit committees, which are composed of members of the board of directors). *See also* Annemarie K. Keinath & Judith C. Walo, *Audit Committee Responsibilities*, 74 CPA J. 22, 23 (2004) (indicating that the Sarbanes-Oxley Act imposes heightened independence requirements on the members of the audit committee).

166. *See* Cuny & Talmor, *supra* note 157, at 632 (suggesting that a managerial process runs the risk of the manager offering misleading or incorrect information because of the impact of such a role on the probability of her job being terminated).

compensation packages to consider. This division in risk tolerance and financial incentives carries with it similar division of motives.

Connectedness to CEO

Connectedness to the CEO might also impact a director's set of motives and could create disparity between different board members.[167] Connectedness to the CEO relies on norms of reciprocity, liking, and social consensus to shape group decision-making processes and increases the CEO's social influence.[168] The CEO connectedness could be appointment-based or social-based. Appointment-based CEO connectedness manifests when directors are appointed during the current CEO's tenure. When more directors are appointed during a CEO's tenure, the CEO's social influence increases because CEOs are involved, directly, or indirectly through consultation with the nominating committee, in recruiting, nominating, and appointing of the directors; those directors are more likely to "share similar beliefs, priorities, and visions with, and may be beholden to, the CEO who appoints them,"[169] more so than directors appointed during a previous CEO's tenure.[170] CEO connectedness based on sharing prior education, employment, or social network ties with directors could also play a factor in board motives, and fraction the board based on vision and underlying business values.

Stock Ownership

Directors also diverge in their financial motives based on their equity ownership and exposure, even when tenure is held constant. Since some

167. *See* Vikramaditya S. Khanna et al., *CEO Connectedness and Corporate Frauds*, 70 J. FIN. 1203, 1204-05 (2015) (finding that appointment-based connectedness weakens the checks and balances required for prevention of corporate fraud because directors appointed by the CEO are more likely to share with that CEO similar beliefs and visions, as opposed to directors not appointed by that same CEO); E. Han Kim & Yao Lu, The Independent Board Requirement and CEO Connectedness 3 (Dec. 8, 2011) (unpublished paper, University of Michigan and Tsinghua University) (on file with University of Michigan) (suggesting that newly appointed directors may be beholden to the CEO who appoints them, while directors appointed by a previous CEO are more likely to challenge a new CEO).

168. *See generally* Robert B. Cialdini, *Principles of Automatic Influence*, *in* PERSONAL INFLUENCE: THEORY, RESEARCH, AND PRACTICE 1, 9-19 (Jacob Jacoby & c. Samuel Craig, eds.) (1984) (asserting that one can subtly gain the compliance of others through triggering various stimuli such as social validation, authority, reciprocity, and friendship).

169. Kim & Lu, *supra* note 167, at 3.

170. *See* Jeffrey L. Coles et al., *Co-opted Boards*, 27 REV. FIN. STUD. 1751, 1753 (2014) (finding that sensitivity of CEO turnover to firm performance decreases and CEO pay levels increase as a result of an increase of CEO appointed-directors on the board); Adair Morse et al., *Are Incentive Contracts Rigged by Powerful CEOs?* 66 J. OF FIN. 1779, 1779 (2011) (arguing that a CEO can directly and indirectly influence the board to slant her performance assessment toward better performing measures).

directors choose to hold their stock longer than the required period of restriction, and some directors are more diversified than others in their overall equity portfolio, it stands that their financial motives and risk aversion would vary based on their equity holdings. Since directors make changes to their stock ownership, these interests are constantly changing.

Serving on Different Committees or Differential Pay

So far, an assumption has been made that director pay is fixed and is identical for all board members. In reality, however, even without supplemental pay, directors are paid in a differential manner—leading to different pay to otherwise similar directors. These different levels of pay can stem from different functions the director serves[171] (i.e., whether they are on the audit committee, serve as the chair, etc.) but also can be because of personal choice as to the portion of payment received in equity, the equity holdings in the company, and whether the company provides initial substantial equity grants.[172]

Sitting on Other Boards and Other Engagements

A related point stems not from the director's incentives or pay from the company, but rather from each director's external set of incentives: specifically, if some directors serve on numerous boards, they might be more inclined to take risk as their human capital might be better diversified. However, a director whose only appointment is with the company might be more reluctant to endanger it, all other things held equal. Similarly, each director's background, stature and other outside sources of income all have a bearing on the motives she brings to the position.

All of the above serves to illustrate the complexity of directors' motives and the myriad of motives already in place on public companies' boards. While supplemental pay to directors might add an additional motive to the board, it is not different than the many pre-existing factors

171. Many boards have specific additional pay for membership in one of the board committees, in particular the audit committee. *See* 2012 SPENCER STUART BOARD INDEX, *supra* note 95, at 40 and accompanying text (reporting in 2012 an average retainer of $11,503 for audit committee members, which is 40% higher than the average amount paid to members of other committees).

172. For instance, Adobe requires each non-employee director to hold 25% of the net shares acquired from Adobe until the total number of shares held by such non-employee director equals or exceeds 6,000 shares and provides an initial grant of RSUs in an amount valued at $450,000 at the time of election. This grant provides variance in the equity compensation in a given year between incumbent and newly elected directors. Adobe Sys. Inc., Proxy Statement (Form DEF 14A) 88-90 (March 1, 2013), http://www.sec.gov/Archives/edgar/data/796343/000079634313000024/adbedef14a2013.htm [perma.cc/3LAE-JDDQ].

that create and comprise each director's motives.

C. *Short-Term Incentives*

While the first two concerns, lack of independence and loss of cohesiveness, touch on the nominees' attributes and impact on the board's work in general, a third concern often raised by opponents of supplemental pay revolves around the interplay between short- and long-term company performance. Opponents of activism by hedge funds often cite the modus-operandi of activist hedge funds as a strategy aiming to gain short term profits at the expense of long-term performance. Against this backdrop, the concern attributed to the structure of the activist nominees' supplemental pay is that it would drive the directors to be more short-term-oriented, even if it is not the best long-term approach because of the short-term structure of the supplemental compensation of these activist-nominees.

Indeed short-termism has been a hot topic,[173] and to a certain extent it might present a corporate governance concern,[174] but there is little reason to believe that short-termism, even if an issue, will be exacerbated due to the presence of activist nominees and their compensation structure. As further detailed below, there are several reasons that should alleviate the concern regarding corporate short-termism in this context.

173. For a summary review of the debate and public attention this debate has generated, see Bebchuk, *supra* note 7, at 723-24.

174. *See, e.g.*, Bratton & Wachter, *supra* note 24, at 674 n.77 (citing a projection of governance incoherence alongside shareholder empowerment that will impose a short-term horizon with harmful effects); Justin Fox & Jay W. Lorsch, *The Big Idea-What Good Are Shareholders*?, 48 HARV. BUS. REV. 49, 51 (2012) (proposing that improving corporate governance in light of short-termism will require separating patient shareholders from short-term traders); Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 26 (2010) (expressing corporate concerns with respect to short-termism); Bill George, *Activists Seek Short-Term Gain, Not Long-Term Value*, N.Y. TIMES DEALBOOK (Aug. 26, 2013, 10:56 AM), http://dealbook.nytimes.com/2013/08/26/activists-seek-short-term-gain-not-long-term-value [perma.cc/JUN2-EBH6] (suggesting that corporate leaders should focus on creating long-term competitive advantage to sustain growth instead of simply trying to meet the short-term numbers); JOHN KAY, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING 9 (2012), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf [perma.cc/F5ZV-PTDR] (identifying short-termism as a problem in UK markets and proposing a solution that includes establishing best practices for key players, including company directors); Martin Lipton, *Important Questions About Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 9, 2013), http://blogs.law.harvard.edu/corpgov/2013/03/09/important-questions-about-activist-hedge-funds [perma.cc/79XX-KME2] (identifying as a critical question whether "best practices" corporate governance is a major factor in short-termism).

1. Activist-Paid directors can only act if they convince other directors

As discussed above, since activist-paid directors are most often a minority group in the boardroom, their ability to steer the corporation into short-termism is limited since they would have to gain the support of some other, management nominated directors who are not paid for short-term performance and who would like to have a long tenure at the company (which could be compromised if they act in short-termism). Assuming these actions are clearly short-term driven,[175] the board is unlikely to adopt them even if the activist nominees are pushing for them.

2. There is no evidence that focus on the short-term hurts long-term

A key component of the argument regarding short-termism is attributing hedge fund activism with short-termism. While it is true that activists usually do not stay in companies for the long term, there is no evidence that their actions and the changes that they advocate for in the short term actually hurt the target's long-term performance. To the contrary, several studies have found the opposite: that activism not only improves short term returns and performance but that such improvement continues into the long term, even after the activist has departed the company.[176] If activists' interventions and actions are good both in the short term and for the long term, structuring director pay as a function of returns in the short to intermediate term should not be so concerning, as it might have other legitimate motives.[177]

3. Since boards have directors with far worse short term incentives, activist-paid nominees might actually be an improvement

As noted above, public companies' boards are already highly diverse in their members' motives and incentives. While the pay structure of activist nominees is often criticized for its focus on short-term return, in reality these activist nominees might have a longer horizon than some other members of the board. For example, a board member who is about to

175. It is important to note that it can be hard to discern short-termism from other actions that might raise both short- and long-term value.

176. For a discussion of different views on short-term and long-term effects of shareholder activism, see generally Bebchuk et al., *supra* note 7, and *supra* note 24 and accompanying text.

177. An activist may not want to pay the directors after it exits and no longer has a stake in the company. A need also exists to induce short-term shocks as discussed *infra* Part V.C.4.

retire, or who has large amount of restricted stock that becomes unrestricted, might have a much stronger incentive to maximize the short term returns on the expense of the long term. Similarly, CEOs and other executives might try to spring-load good news and engage in other short-term behavior to maximize their options value.[178] Lastly, if one is concerned with activists' short term interests, it stands to reason that having the activists themselves on the board is an even worse option than having an outside nominee who is paid by the activist. Assuming the activist gets a seat anyway, it might be preferable to have non-affiliated nominees who may earn their pay under more limited conditions and who have less skin in the game than the activist itself. Against this backdrop, appointing non-affiliated activist-paid directors might actually improve the board's long term view and reduce the risk of short-termism, and not the other way around.

4. In certain circumstances short-term incentives are good

While normally, the long-term horizon is important and directors' compensation structure should reflect it, activist hedge funds focus on a subset of target companies that might require short-term shocks. Against the backdrop of long-term focus in the compensation plans of management and current directors, one might want an influx of short-term incentives to help drive and implement the necessary short term shock. In this sense, in some cases having a few directors with short-term incentives might help balance out an overly conservative board.

V. CHARTING ACTIVIST-NOMINEES PAY ARRANGEMENTS – KEY FACTORS TO CONSIDER

So far, a strong case has been made that activist-paid directors do not justify the strong outcry that surrounds them, and given the current corporate governance landscape, they might actually pose a lesser concern than some of their fellow directors. However, one still cannot completely ignore some of the concerns payments to activist-nominated directors may raise. While as a whole activist-paid nominees may prove beneficial to shareholders, the specifics of these compensation arrangements are germane to establishing the level of concern one should have regarding

178. Robert Daines et al., Right on Schedule: CEO Option Grants and Opportunism at 42 *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2363148 (documenting negative abnormal returns before scheduled option grants and positive abnormal returns after the grants. These returns are explained by measures of a CEO's incentive and ability to influence stock price).

their arrangements with the activist. This Part delineates some of the key factors that could help shareholders, proxy advisors, and companies in assessing the true risk these payments may pose.

In particular, it is important to use a three-layered approach to assessing any compensation arrangement between an activist and a potential nominee. This approach should examine how likely the concerns regarding short-termism, lack of independence, and damage to board cohesiveness are to transpire given (a) the activist's background and intentions, (b) the nominee's background and history with the activist, and (c) the specifics of the compensation arrangements that were put in place. The evaluation of these three components and the interplay between them could help to establish a "safe-zone" or in raising "red flags" for shareholders' consideration.

A. *The Activist*

Not all activists are made equal. While all hedge funds are driven by value creation to their investors, their approach to their target companies, and the value to the long-term shareholders of these companies, differs greatly. While some activists are truly interested in the long-term health and prosperity of the company, and evidence suggests this is most often the case,[179]in some cases the activist intends to generate profits on the expense of the target company, either by spiking short-term returns at the expense of long-term prosperity, by engaging in financial manipulation, or by empty voting due to conflict of interests.[180] Therefore, it is imperative to key-in on some of the main factors that could provide shareholders a better gauge as to the activist's true intentions for payments to its nominees.

Full Disclosure of the Compensation Arrangement

While this point might seem obvious, in reality activist hedge funds are not subject to the same disclosure rules as their targets, public corporations. Since the playing field is tilted, it is extremely important to even it out as much as possible through the production of a full and complete disclosure of the compensation arrangements with the nominee.

In most cases, the activists will disclose the agreements with their nominees in their proxy materials, since they have officially launched, or announced intent to launch, a proxy contest and are bound by the SEC

179. *See* Bebchuk et al., *supra* note 7, at 711 (finding no evidence for the concerns of activist intervention).

180. *See* Hu & Black, *supra* note 24, at 823 (discussing the mechanics of empty voting); Kahan & Rock, *supra* note 7, at 1076 (describing empty voting as an example of the same conflicts of interest problem created by the separation of legal and beneficial ownership).

requirements.[181] However, there are several instances where the activist might not be bound by these requirements, such as when the activist has reached an agreement with management prior to launching a proxy fight and before a filing of a 13D form, or before it made its intentions publicly known.

Importantly, in some instances, the activist might disclose only the key details of the agreement without sharing the full form or even refrain from disclosing it at all.[182] Since the details of any compensation arrangement are vital, lack of full disclosure of the executed agreement with the nominee, should, in itself, raise a red flag.

Full Disclosure of Other Ties With the Nominee

A second layer of information that could prove beneficial in assessing the activist's intentions revolves around the relationship the nominee has, or has had, with the activist. Did the nominee serve as a director on behalf of the activist in the past? Does she receive other monetary compensation that is not directly related to the case in question such as consulting fees? Does she have an equity stake in the activist itself?

The Time Horizon of the Activist:

Many of the concerns regarding shareholder activists in general, and

181. The disclosure of these arrangements could occur as part of the reporting duties imposed when an activist crosses the 5% threshold, including the filing of Schedule 13D.

182. Some believe that the current regulatory framework has too many loopholes that allow the activist to not disclose these arrangements if it wishes to do so, since there is no specific requirement under the current U.S. securities rules for the disclosure of *all* (i) compensatory arrangements between a board nominee and the nominating shareholder or (ii) conflicts of interest presented by compensatory arrangements between a nominee and a nominating shareholder. While Item 5 of Schedule 14A that governs proxy solicitations by an activist requires some disclosure regarding arrangements between a nominating group and the nominee, such disclosure requirements are not nearly as specific or prescriptive as the comprehensive disclosures required for compensation paid by an issuer to its officers and directors under Item 402 of Regulation S-K. *See* 17 C.F.R. § 240.14a-101 (2015) (requiring brief descriptions of substantial direct or indirect interests by certain participants in the proxy contest); Letter from Jeff Mahoney, Gen. Counsel, Council of Inst. Investors, to Keith F. Higgins, Dir. of the Div. of Corporate Fin., U.S. SEC Re: Compensation Arrangements between Nominating Shareholders and Board Nominees at 4 (March 31, 2014), http://www.cii.org/files/issues_and_advocacy/correspondence/2014/03_31_14_CII_letter_to_SEC.pdf [perma.cc/38QS-M3WT] (asserting that the disclosures required by Item 402 of Regulation S-K are more comprehensive than disclosures required by Item 5 of Schedule 14A); *see also* Sabastian V. Niles, *CII Urges SEC to Require Disclosure of Third-Party Director Compensation*, THE HARVARD LAW SCH. FORUM ON CORPORATE GOVERNANCE & FIN. REGULATION (May 14, 2014), http://blogs.law.harvard.edu/corpgov/2014/05/14/cii-urges-sec-to-require-disclosure-of-third-party-director-compensation/ [perma.cc/39VC-KX4R] (agreeing with the CII's concerns regarding the line-item disclosure requirements).

in the context of director nomination in particular, stem from their relative short-term positions in their target companies.[183] Since the activist intends to exit in the short-term, a concern arises that the activist's short-term interests might not align with the long-term benefit of the company. While these concerns are largely unsubstantiated as an outlook of activists as a group, it is not possible to rule out cases in which the activist might try to reap short-term profits on the expense of long-term value. In that context, the activist can alleviate shareholder's concerns through two channels. First, it can structure the compensation arrangements with the nominee in a manner that would enhance the likelihood of long-term value creation, as detailed below. Second, the activist can itself commit to hold the stock for a specified duration. If the activist promises to hold stock in a positive net position throughout its proposed turnaround plan, shareholders can be more confident that the activist has the right incentives. In this sense, there is a balance between the pay structure and the activists' own time horizon.

Activist History and Track Record:

While the past does not guarantee the future, activists' past engagements can inform shareholders of the activists' methods and business models, and in turn, the level of concern their payments to nominees should raise. Does the activist tend to seek confrontation with the existing board or does its appointment fit in seamlessly? How long does the activist generally hold the share of its targets? Does the activist focus on financial or operational changes? Did the activist engage in payments in the past? Were the payments to, and the profile of, the nominees necessary to the business model the activist seeks to promote? All of these questions could help in assessing the general level of scrutiny these pay arrangements should receive.[184]

The Activist Proposed Business Plan and The Impact The Nominee Can Have In Fostering It:

As discussed above, the compensation arrangement may be needed in order to allow the activist to attract the most suitable nominee. If that is the

183. Most activists exit their targets within 2-3 years. *See e.g.*, Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. OF FIN. 1729, 1749 (2008) (reviewing the exiting process for hedge funds); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. OF FIN. 187, 220 (2009) (examining the effects short-term activist investors have on their target firms).

184. For instance, one can contrast the business model and history of Value Act and Pershing Square. While Value Act focuses on a collaborative model with existing board and management, and usually holds its share for lengthy periods of time, Pershing Square is more focused on confrontational tactics attempting to gain control.

case, then it follows that the business plan and the nominee must have a clear linkage and that the payment is for the specific qualities the nominee possesses and not as a bonding arrangement with the activist.

B. *The Pay Design*

Similar to the activist, not all pay arrangements are created equal. Some might focus on cash, some on equity; some might require a holding period while some might not. In assessing an activist-paid nominee's candidacy, the pay design chosen by the activist is germane to an assessment of whether shareholders should be concerned. In this context the pay design should specifically reduce the concerns that (a) the nominee would continue to be tied to the activist's interests, even when in clash with those of the company, after her election and (b) that the pay structure does not encourage short-term value manipulation. In doing so, shareholders should examine the structure of the payments, their duration and the timing and the total value of the compensation.

Composition

Similar to CEO and director compensation, the structure in which the payments are given is crucial to their evaluation.[185] Among the factors that shareholders would need to weigh is whether the compensation is given in all cash or in equity (or the ratio of cash to equity). As cash compensation increases, the concern is that the nominee would act to the benefit of the activist and not the company in conflicted scenarios. If some of the compensation is given in equity and tied to performance, is it tied to the company's performance or the activist's performance? If the compensation includes options, are they deeply out of the money, thus driving the director to take excessive risk or bump short term share price?

Duration and Timing

The duration and timing of the compensation are also important to the assessment of the risk of short-termism and lack of independence. If the nominee receives the pay in one upfront payment, it might reduce its dependence on the activist. If, however, the pay is in several installments that are dependent on the activist's judgment or performance, such dependence might be long-lasting. If some of the compensation is given in

185. *See, e.g.*, INST. S'HOLDER SERV. INC., 2013 U.S. PROXY VOTING SUMMARY GUIDELINES 38, 41 (Jan. 31, 2013), http://www.issgovernance.com/file/files/2013ISSUSSummaryGuidelines1312013.pdf [perma.cc/U8PF-UD9W] (enumerating the factors that should be considered when voting on Say-on-Pay and Golden Parachute proposals).

equity is there a holding period that would ensure that the nominee would have the long-term interests of the company in mind? Can the nominee sell its equity in the company prior or immediately after the departure of the activist or does it require a holding period that lasts beyond such point, minimizing the risk of timing the market? Similarly important is the question of whether the compensation is front or back loaded.[186]

Activists could easily structure the pay in a manner that is more long-term oriented. For instance, such pay could be based on a five-year period and not the three-year period that was previously offered. Pay could be further delayed and given at some point after the director's departure, or the activist could require the nominee to buy the target's stock with the proceeds of the pay.

Total value

Equally important to the general design of the pay package is the assessment of the total potential value of the compensation. In particular, shareholders would need to assess whether the pay is aimed at compensating the candidate for her willingness to endure the challenging process of a proxy fight or at reflecting a form of "loyalty-buying" by the activist.

C. *The Nominee and Her Clout Within the Board*

While the activist and the pay design form the first two legs of the evaluation-triangle, the nominee and her estimated clout in the board are equally important. Assuming shareholders approve of the activist's agenda but are concerned that a paid director might eventually sacrifice shareholders' interests, their assessment of the tradeoff between the risks of such pay and the benefits of the candidate and the plan cannot be done in a void. The nominee's own stature and record, as well as her relative position in the board if elected, are also important factors that should be considered.

Relative power of the paid director

While one might try to equate activist-paid directors and their pay design with CEO nomination and pay, the election of a director and the potential pay package she might receive differ greatly from that of a CEO. Since the board has several members (on average close to 11), and in most

186. Timing of the pay reflects a trade off in the nature of the concern: if payment is made in full early on, it might lead to less dependence on the activist in the long term. That said, it might also lead to more incentive for short-termism if the pay is in equity that is not restricted.

cases the activists aim for a minority slate, even if the activist puts several of its nominees on the board, their ability to stir the corporation one way or the other is dependent on the approval of the directors that are not paid by the activist. As such, any concern that the payment might lead the director to act against shareholders' long-term benefit is strongly correlated to the level of concern shareholders have regarding the board as a whole and the relative clout the activist-paid nominees are expected to gain.

The Nominee's Track Record

Holding pay design constant, the nominee herself can provide important context against which the other factors should be considered. Is the nominee a repeat player with ties to the activist or to other activists? Was she nominated by the activist in the past or is likely to prefer the activist agenda at all times? Do the nominee's resume, track record and alternative options justify a supplemental pay arrangement?

Sensitivity to Compensation

The pay design and pay levels cannot be examined detached from each nominee's sensitivity to such compensation. Even if the pay design is inadequate, the nominee's current assets might make the payments immaterial to her decision-making. Similarly, the nominee's desire to protect her human capital as a future director and reputation might reduce her sensitivity to the pay-incentives in cases where a conflict arises.

All of the above reflects the plethora of factors that are necessary for an informed decision regarding supplemental pay. While shareholders might not wish to delve into each of these factors, it is clear that some key factors could help them in classifying a pay package as concerning or not. An all-cash pay that is given in installments should raise red flags. Lack of disclosure should raise red flags. Tying the pay to the activist performance and not the company should raise red flags. A nominee that does not provide a unique skill set but is compensated should raise a red flag. Alternatively, a commitment from the activist to hold shares as long as his candidates are on the board should alleviate concerns. A pay package that is crafted to detach the nominee from the activist performance and is geared to incentivize long-term performance should do the same. A nominee with a unique skill set and with strong reputation could also contribute to such designation.

While the interaction between all three legs will not always produce a bright line answer, the ability to identify those gray cases would allow shareholders to focus their efforts and time on the right cases without the need to overreact to what could be a positive development, one that surely does not merit the current hysteria surrounding it.

VI. CONCLUSION

Do activist-paid directors pose a grave concern to the corporate governance of public companies? In several recent cases activist hedge funds have attempted, and in one case succeeded, to place an activist-paid director on the target's board. These attempts have spurred a strong backlash from companies, practitioners and academics cautioning against the great dangers this emerging practice entails. Lack of independence, erosion of cohesiveness and concern regarding short-termism have all been enlisted in the fight against these pay arrangements. Investors are continuously cautioned that the emergence of activist-paid directors is a drastic move that shakes the current confines of board best practices.

This Article strives to burst this rosy bubble regarding board of directors' structure and independence that is painted by those advocating against supplemental pay. Specifically, this Article argues that current boards have already been suffering from many of the issues that those opposing supplemental pay are invoking, that activist-paid directors are not expected to change such landscape dramatically, and that given the benefits supplemental pay presents to shareholders and boards themselves, this categorical opposition to supplemental pay is unmerited. Instead of an unfounded hysteria over these pay structures, this Article suggests that a more nuanced approach is warranted, an approach that balances between the benefits these marquee directors could provide on the one hand and the valid concerns some pay arrangements might present on the other. In doing so, this Article presents key factors each board and shareholder base should evaluate when an activist hedge fund seeks to appoint a director with a supplemental pay arrangement.