Client Alert

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Corporate Governance

Compensatory Arrangements Between Hedge Funds and Their Director Nominees

During the 2013 proxy season, there were several proxy contests led by so-called activist hedge funds. Most of these proxy contests involved “short slates” where board control was not at issue. With a few exceptions, the two leading proxy advisory firms, Institutional Shareholder Services (“ISS”) and Glass, Lewis & Co. (“Glass Lewis”), recommended in favor of one or more of the dissidents’ nominees.

One troubling development arising from these proxy contests was compensation arrangements that two hedge funds entered into with their director nominees. This occurred in connection with Elliott Management’s proxy contest at Hess Corporation (“Hess”) and efforts by JANA Partners to elect directors at Agrium Inc. (“Agrium”). If elected, the dissident nominees would have been entitled to significant compensation from the hedge funds based on various metrics tied to the companies’ respective financial performance. This development raises a number of concerns, especially whether it gives the director-nominees a financial incentive that may not be aligned with the long-term best interests of the corporation. Equally troubling, the proxy advisory firms did not recommend against the director-nominees based on these compensation arrangements.

Background

At Hess, Elliott Management proposed splitting the corporation into two companies and nominated five individuals to serve on Hess’s 14-member board. Elliott Management, which owned approximately 4.5% of Hess’s common stock, disclosed that, in addition to paying each of its nominees a one-time $50,000 cash fee for standing for election, it had also agreed to pay the nominees $30,000 for every percentage point that Hess’s stock outperformed a peer-group over a three-year period following the directors’ election. The payment was capped at $300,000. Elliott Management’s nominees were supported by ISS and Glass Lewis despite these compensatory arrangements. Prior to the meeting, however, Elliott Management’s nominees agreed to waive their right to these payments. Ultimately, Hess settled with Elliott Management before the shareholder meeting by agreeing to separate the roles of its chairman and CEO and seating three of Elliott Management’s five director nominees.

At Agrium, 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. JANA Partners claimed that Agrium had underperformed its peers by 160% in recent years. The proxy advisory firms split on their recommendations, with Glass Lewis recommending in favor of Agrium’s nominees and ISS supporting the dissident’s nominees. Ultimately, Agrium’s shareholders voted in favor of management’s slate.

Observations

These compensation arrangements were the subject of significant public debate, including with respect to whether they were consistent with the directors’ fiduciary duties or would otherwise render the dissident directors “interested” or not independent. As Professor Stephen Bainbridge of the UCLA School of Law

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stated, "[i]f this nonsense is not illegal, it ought to be." Many observers were also surprised that the proxy advisory firms recommended in favor of most of these nominees and wondered if such recommendations were consistent with the goals and interests of their clients.

These compensatory arrangements are of concern because they give the dissident nominees a personal financial incentive to pursue actions that will yield demonstrable results within three years. Of course, not all strategies of shareholder activists threaten the long-term interests of a corporation. In addition, all shareholders presumably benefit from the company's improved financial performance during the three-year period. It is possible, however, that these incentives could cause the directors to approve actions that could harm the company beyond the three-year period or otherwise lead to decisions that favor near-term results. As Professor John C. Coffee, Jr., of Columbia Law School observed, assume that:

> Two years from today, a bidder might offer a 50% premium ($60 for a $40 stock). But for these bonuses, the directors might all believe it was better to decline this offer, because the company's long-term value in two or three more years was expected to exceed the current premium.

The key issue in the underlying debate over these arrangements—and many activist agendas generally—is defining the appropriate horizon for measuring shareholder interests. The hedge funds argued that a three-year period was sufficiently long to align the interests of the nominees and other shareholders, given that the compensation was tied to the companies' stock price and/or ability to outperform peers. Many long-term investors, however, are investing for periods significantly longer than three years. *See* 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, 12 (2010) ("The focus of many of these institutions on quarterly earnings and other short-term metrics is fundamentally inconsistent with the objectives of most of their end-user investors, people saving primarily for two purposes, to put their kids through college and to fund their own retirements."). In addition, because these nominees were entitled to cash bonuses rather than equity, it is not clear that they were exposed to any significant "downside" if their proposed strategies failed. The hedge funds would suffer from any drop in the companies' stock prices, but nothing prevents the hedge funds from exiting their positions and leaving long-term investors to suffer the consequences.

These compensatory arrangements could also risk further undermining boardroom collegiality after a proxy contest. In particular, they could create warring factions on the board of directors, where incumbent directors are suspicious of the dissident directors' motivations.

Few, if any, companies expressly prohibited such compensatory arrangements prior to the 2013 proxy season. Rather, it is more common for advance notice bylaws to require that a nominee disclose any such compensatory arrangements. Following the Hess and Agrium shareholder meetings, however, some commentators have recommended that bylaws be amended to impose a director qualification that would prohibit a person from serving as a director if he or she had any third-party compensatory arrangements relating to director service. We believe most companies are taking a "wait and see" approach on this issue. Given the significant criticism levied at this practice, that Hess's nominees ultimately waived their rights to the compensation, and that JANA's nominees were not elected, it is not clear whether activist hedge funds will continue to pursue this strategy. Nevertheless, that the leading proxy advisory firms indirectly endorsed the practice by recommending in favor of some of these dissident slates suggests that this issue may not go away.

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