

## SPECIAL COMPENSATION ARRANGEMENTS FOR DISSIDENT DIRECTORS IN PROXY CONTESTS: A POLICY ANALYSIS

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*Dissident shareholders in recent proxy contests have sometimes promised to pay their nominee directors special compensation based on stock returns over a defined period. Some commentators have called for the prohibition, by law or corporate by-law, of such special compensation agreements. This article rejects such a ban. Some express concern that the agreements give rise to perverse short-term incentives. While there are trade-offs in setting incentive compensation, the incentives associated with these agreements ought simply to be another consideration, positive or negative, for shareholders in voting in any given contest. Moreover, dissident nominees can usefully signal confidence in their capacity to enhance value by agreeing to accept such incentive-laden pay. Some also express concern that special compensation undermines director independence, paid as it would be by a third party. But clearly defined stock-based compensation can enhance independent thinking: directors have a counterbalance to natural feelings of loyalty to the dissident shareholders since they have a clearly defined financial stake in the company. Moreover, third-party payment is common in other contexts, such as private equity, without calls for blanket prohibitions. Finally, some predict that the proposed compensation packages for dissident directors would balkanize the board. But pay variation across directors is ubiquitous, and is a much smaller threat to the unity of the board than the possibility of a short slate of directors, yet neither differential pay nor short slates are controversial (nor should they be). The article concludes that while disclosure of the proposed agreements should be mandatory, shareholders should be able to accept or reject director slates proposing special compensation on a contest-by-contest basis.*

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## I. INTRODUCTION

Proxy contests at public traded companies have never been so common. Canada has seen a remarkable 84% increase in proxy contests in 2004-2008 compared to the previous five-year period.<sup>1</sup> The explanation for the increase rests in part on the emergence of activist shareholders of various stripes, especially hedge funds, who have concluded that it is a profitable strategy not simply to advocate for changed strategies at the businesses in which they invest, but also sometimes to campaign for different management in proxy contests.

In waging these contests, some hedge funds have recently adopted a practice that many consider inappropriate. On top of paying their nominee directors cash compensation for agreeing to participate in the proxy contest, and/or for succeeding in the contest, hedge funds have on recent occasions promised to make payments to their nominees that depend on how the stock price of the target company performs over some time horizon. For example, Elliott Management, the second largest shareholder of Hess Corporation with 4.5% of shares, initiated a proxy contest to gain seats on the board. Elliot proposed to pay nominees a flat fee of \$50,000. In addition however, if an Elliot nominee were elected as a result of the contest, all the nominees would receive a bonus at the end of three years if Hess stock were to outperform industry peers. Under the arrangement, directors are paid at least in part by Elliott Management, not by Hess Corporation. The matter of compensation was controversial, and in the end, Elliott's nominees agreed to waive the arrangement because it had become an "ongoing distraction."<sup>2</sup>

In the contest for board positions at Agrium Corporation, the dissident was a hedge fund called Jana Partners that agreed to pay its nominees a share of the profits that Jana realized in the three-year period after the proxy contest. This was significantly

1. Fasken Martineau LLP, "2013 Canadian Proxy Contest Study" (2013), available online at <[http://www.fasken.com/en/canadian-proxy-contest-study\\_e/](http://www.fasken.com/en/canadian-proxy-contest-study_e/)>.
2. See, e.g., Lawrence Cunningham, "Director Bonuses for Performance, Prawn Debate and the Bigger Picture for Hess" (May 1, 2013), online: *Concurring Opinions* <<http://www.concurringopinions.com/archives/2013/05/director-bonuses-for-performance-and-the-bigger-picture-for-hess-shareholders.html>>; Brandon Gold, "Why the Wachtell Bylaw on Director Compensation by Shareholders is Overbroad and May Fail Blasius Scrutiny" (2013), online: *The CLS Blue Sky Blog* <<http://clsbluesky.law.columbia.edu/2013/05/31/why-the-wachtell-bylaw-on-director-compensation-by-shareholders-is-overbroad-and-may-fail-blasius-scrutiny/>>.

controversial, with Agrium and other critics characterizing the Jana nominees as being bound by “golden leashes.”<sup>3</sup> Jana eventually lost the proxy contest.

Several commentators have weighed in on the practice of special compensation for dissident nominee directors. The basic argument in the commentary in favour of the practice is the same as the argument in favour of performance-based pay generally: it helps align the interests of the board with the interests of shareholders.<sup>4</sup> The arguments against special compensation are more varied. At root, there are two concerns. First, the compensation may create perverse incentives for the nominee directors.<sup>5</sup> Second, the company does not pay the special compensation, but rather a third party does. This raises the concern that the compensation structures compromise the authority of the board and the independence of the nominees.<sup>6</sup> Similarly, some argue that the presence of some directors on the board with such incentives threatens to “balkanize” the board into dysfunctional, competing groups of directors who identify the other group as antagonists rather than colleagues.<sup>7</sup>

Concerns over special compensation have led some to advocate that the practice be made illegal. Lipton quotes Bainbridge as saying, “If this nonsense is not illegal, it ought to be.”<sup>8</sup> Lipton does not himself necessarily go this far, instead advising boards to consider adopting a by-law that would prohibit directors from entering into such deals. Erlichman writes that, “The Coalition for

3. See, e.g., Peter Goven, “Jana’s Agrium Proxy Battle had Little Chance of Succeeding”, *Financial Post*, April 12, 2013, online: *Financial Post* <<http://business.financialpost.com/2013/04/12/agrium-story/>>; Stephen Erlichman, “Agrium payments don’t pass the ‘smell test’” *The Globe and Mail*, July 4, 2013, online at <<http://www.theglobeandmail.com/report-on-business/payments-dont-pass-the-smell-test/article13010420/#dashboard/follows/>>.

4. See, e.g., Cunningham, *supra*, footnote 2; Gold, *supra*, footnote 2.

5. See, e.g., John Coffee, “Shareholder Activism and Ethics: Are Shareholder Bonuses Incentives or Bribes?” (2013), online: *The CLS Blue Sky Blog* <<http://clsbluesky.law.columbia.edu/2013/04/29/shareholder-activism-and-ethics-are-shareholder-bonuses-incentives-or-bribes/>>.

6. See, e.g., Steven Davidoff Solomon, “Upping the Ante in a Play for a Stronger Board” (April 2, 2013), online: *New York Times* <<http://dealbook.nytimes.com/2013/04/02/upping-the-ante-in-a-play-for-a-stronger-board/>>; Coffee, *supra*, footnote 5, Erlichman, *supra*, footnote 3.

7. See, e.g., Martin Lipton, “Bylaw Protection Against Dissident Director Conflict/Enrichment Schemes” (May 10, 2013), online: Harvard Law School Forum on Corporate Governance and Financial Regulation <<http://blogs.law.harvard.edu/corpgov/2013/05/10/bylaw-protection-against-dissident-director-conflictenrichment-schemes/>>.

8. *Ibid.*

Good Governance believes that vote buying and golden leashes used in the battle for control of Agrium fly in the face of what Canadian shareholders deserve, and should not be allowed.”<sup>9</sup>

The intensity of the disagreements over the practice, and the proposals to regulate it either through general law, or through the private adoption of by-laws, invite a closer analysis of the merits and demerits of these special compensation arrangements. In my view, while the practice of providing nominee directors with special compensation packages is not without potential problems, there are good reasons to allow these deals. Moreover, closely analogous practices are far more commonplace, apparently without controversy, than commentary has recognized. On balance such side deals should not be categorically banned either by public regulation or by private adoption of by-laws. By all means shareholders may wish to consider whether the existence of such arrangements ought to influence their vote, but the matter should be left in their hands on a contest-by-contest basis.

The article proceeds by reviewing the different kinds of considerations that commentators on both sides have raised when analyzing special compensation arrangements in proxy contests. First, the paper reviews the role of special arrangements as potentially efficient or inefficient compensation devices. This section notes the role of the agreements in generating director incentives, which has been recognized in earlier commentary, but also in creating a signal to the market: the arrangements allow nominee directors to signal to shareholders their confidence in their ability to enhance corporate value, information which is of potentially vital importance to shareholders in voting in proxy contests. The important signalling implications of these arrangements have been overlooked.

Second, the article examines the potential harm to director independence that the deals may engender, acknowledging the risks, but noting that in fact special compensation may *promote* independence in important ways.

Third, the article reviews arguments that the arrangements threaten to balkanize the board of directors. The section points out that very significant variation in pay packages within a board of directors is remarkably common; if balkanization is not so serious a concern as to warrant intervention in other settings, it is difficult to see why it would be different with special compensation arrangements in proxy contests. Indeed, the clearest threat of

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9. Erlichman, *supra*, footnote 3.

balkanization that proxy contests impose on boards arises from the ability of a dissident to nominate only a minority of directors. The law, while presumably cognizant of the potential for disharmony that a short slate presents, allows shareholders to vote on whether to accept this risk. It is difficult to imagine why the much weaker threat to board unity posed by special compensation arrangements ought not also to be subject to the collective wisdom of a shareholder vote.

The final section summarizes and concludes with a discussion of disclosure rules. The analysis up to the conclusion assumes full disclosure of any special compensation arrangements, and the conclusion examines this premise more closely. The conclusion notes a provision under Canadian securities law that arguably mandates disclosure of these arrangements, and concludes that, within the context of broad disclosure requirements in proxy contests, there is a case for mandating disclosure of special compensation arrangements.

## II. THE KEY ISSUES

### 1. Incentives and Information

#### *(a) Incentives and Special Compensation Arrangements*

Commentary on both sides of the debate about special compensation arrangements for nominee directors has invoked the effect that the arrangements have on incentives. Supporters of the arrangements have argued that they have the merit of incentivizing the nominee directors to act in a manner that maximizes share value.<sup>10</sup> These arrangements can create strong incentives to enhance the share price, which can be a win-win for the shareholders (including the sponsoring dissident) and the directors in question.

On the other hand, the opposition to the compensation arrangements also turns in significant part on the incentives that they generate. In particular, a number of observers have expressed concern about the short-termism that the arrangements might generate. Coffee, for example, argues that directors with, say, a three-year horizon for maximizing share value might engage in conduct that is good for shareholders in the short run, but not the long run.<sup>11</sup> For instance, a director with such a deal in place might

10. See, e.g., Gold, *supra*, footnote 2; Cunningham, *supra*, footnote 2.

11. Coffee, *supra*, footnote 5. See also, Erlichman, *supra*, footnote 3.

be inclined to accept a takeover bid if it increases share price in the short run even if the director believes that in the long run share value will be greater by rejecting the bid. Alternatively, the director might increase leverage because it is good for the shareholders in the short run even if it lessens the ability of the company to withstand downturns.

The debate over the nature of the incentives generated by special arrangements for nominee directors is in the end no different from the usual debates about optimal compensation arrangements in corporate governance, but just situated within the proxy battle context.<sup>12</sup> Several issues are prominent here, as they are whenever optimal compensation is mooted. One important question is whether the stock market provides appropriate measures of success. An important further question is whether the stock market is informationally efficient. If markets are efficient, the stock price generally will reflect investments in future earnings, as well as sacrifices of future earnings for short run gains, and therefore is a good measure of performance. Of course, whether stock markets are efficient is a matter of great debate.<sup>13</sup> If they are not, but rather focus too much on the short run, for example, then of course special compensation arrangements, and indeed any incentive pay plan, ought to go lightly on stock-based incentives.

There is also the issue of an excessive focus on stock value, rather than overall value. For example, leverage can increase share value at the expense of overall value; increasing leverage may lower overall value, but shift value from existing creditors to shareholders. This is a well-known danger, and creditors are wise to include contractual limits on this strategy when initially lending to the corporation.<sup>14</sup>

Even if stock markets are the appropriate measure of corporate success, the negative commentary on special compensation arrangements also calls into question the time horizon that the arrangements contemplate. This too is nothing new. The optimal structure of stock-based compensation is a widely-debated topic.

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12. Cunningham, *supra*, footnote 2.

13. The ongoing debate is nicely illustrated by the awarding of the Nobel Prize in economics in 2013, which was shared in part by economists Eugene Fama and Robert Schiller, who hold strongly opposing views about the efficiency of markets.

14. It is also appropriate to note that it would be odd to reject stock-based deals for dissident directors because of their failure to account for the interests of debt-holders when it is shareholders, and only shareholders, that vote in a proxy contest.

Stock or option awards without any vesting requirements raise the danger of incentives to pump up the stock price in the short run (assuming this is possible, which is questionable if markets are efficient), while sacrificing value in the longer run. On the other hand, stock or option awards that must be held by managers for very long periods have other negative effects, including exposing the manager to greater risk over which she may have little control.

The debate over the incentive structures that special arrangements may involve is a legitimate one: there are both advantages and disadvantages to virtually any kind of incentive structure that one proposes, and this is no different for the proxy nominees than for other directors and executives. A key question, then, is how best to resolve the debate. One option is to declare the arrangements illegal as a matter of regulation, or to ban them with by-laws. Another is to require full disclosure and have the shareholders decide in any given case. Given that there are clearly potential advantages of special compensation arrangements, it is appropriate to leave it to shareholders to decide in the proxy contest itself.

Many commentators concerned about the structure of executive compensation have advocated “say on pay” measures that allow shareholders at least to express disapproval of compensation packages.<sup>15</sup> The proxy contest is an even better forum for shareholders to express their views of a special compensation package for dissident nominee directors. For one, the incumbent slate has strong incentives to point out the perverse incentives that the special arrangements might create, while the dissident group have incentives to emphasize the positive. In the to and fro of a proxy contest, the shareholders are likely to end up with much better information about the likely effects of the compensation arrangements than an ordinary say-on-pay vote. Moreover, if shareholders do not like the proposed arrangements for the dissident nominees, the vote is determinative, not merely precatory: the nominee candidates will not take office.

More foundationally, if proxy contests are understood to be a useful corporate institution, this must rest on confidence in the capacity of shareholders to make informed decisions about fundamental, indeed the most fundamental, questions about corporate direction. The campaigning of both sides in such a

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15. For discussion of the advantages and perils of say on pay, see Jeffrey Gordon, “‘Say on Pay’: Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In” (2009), 46 *Harv. J. on Legis.* 323.

contest, input from proxy advisors and the presence of sophisticated institutional investors provide some basis for this confidence. In a context where so much depends on shareholder voice, it would be jarring to deny them the right to vote for, or against, nominees who have such incentives in place.

Coffee seems to suggest that shareholders may face an unpalatable choice if special compensation arrangements are permissible.<sup>16</sup> In responding to Gold's argument that if shareholders vote for a dissident with such arrangements in place, they must implicitly have approved the arrangements, Coffee states:<sup>17</sup>

Second, Mr. Gold asserts that if shareholders elect the insurgent nominees, their election implies that shareholders have approved the incentive compensation from the hedge fund. But that conclusion simply does not follow. In reality, two issues have been bundled: (1) Should the insurgents be elected, and (2) Should the bonus compensation be paid. Shareholders could rationally believe (1) that a board needed some outsiders focused on shareholder value maximization and (2) that third party compensation was undesirable. In a given case, they could decide that (1) outweighed (2).

In a vote the shareholder can only vote the dissident nominees up or down. They cannot choose from a menu.

Coffee makes the accurate observation that approving both dissident nominees and compensation arrangements in a bundled vote is not the same thing as voting for dissidents on their own without compensation arrangements in place. But it is not at all clear what the point of this observation is. Coffee himself does not clarify and moves on to discussing conflicts of interest and special arrangements, which are considered below. Whatever Coffee had in mind,<sup>18</sup> the observation about bundled voting fails to provide a basis for prohibiting special arrangements.

For one thing, Coffee expresses concern that disfavoured compensation arrangements may be bundled with favoured nominees, but the mirror opposite case could also arise: shareholders may prefer the incumbent group all things equal, but with the incentives generated by the special arrangements, may prefer to vote for the dissident group. Banning the incentives thus would result in the shareholders' less preferred choice prevailing. This

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16. John C. Coffee, "The Wachtell Bylaw: A Balanced Perspective" (May 31, 2013), online: *The CLS Blue Sky Blog*, <<http://clsbluesky.law.columbia.edu/2013/05/31/the-wachtell-bylaw-a-balanced-perspective/>>.

17. *Ibid.*

18. In "A Balanced Perspective", *ibid.*, Coffee does not suggest that special arrangements should be banned, but rather such arrangements should affect determinations of independence. I consider independence below.



consideration is especially important in light of the fact that dissidents have strong incentives to give shareholders what they want.

Moreover, the fact that voting only permits the shareholders binary expressions of their views is endemic. For example, a dissident group may propose a nominee that the shareholders prefer to an incumbent director, but shareholders may collectively prefer even more another prospective nominee that the dissident group did not propose. It would be peculiar to view this as problematic: the purpose of shareholder voting is not to ensure that the corporation is maximizing value on all fronts at once, but rather its binary nature inevitably implies that its goal is simply to ensure better that a value-improving decision is made. If a slate is elected with special arrangements in place, the shareholders have calculated that this is the value-enhancing decision; it should therefore be adopted. Tinkering with the choice set that shareholders can consider in an attempt to make shareholders better off would be inconsistent with this model.

To summarize, it is true that the incentives that compensation arrangements generate can be constructive or destructive. The proper forum in any given case for resolving this debate is the proxy contest itself, just as the contest resolves a host of other very important questions about the corporation's direction.

*(b) Signalling and Special Compensation Arrangements*

Commentary to date on the incentive pay aspect of special compensation arrangements subject has missed an important way in which incentive pay has features that are uniquely important in the proxy contest setting, or at least are radically more important in a proxy contest setting than in other contexts. Gold comes closest by arguing that the arrangements may be important in recruiting qualified nominee directors to agree to be candidates.<sup>19</sup> Candidates in heated proxy contests at the very least will be subject to unpleasantness as their motives and qualifications are questioned, and most likely will be subject to non-trivial reputational risks.<sup>20</sup> Gold defends special arrangements for dissident nominees in part out of concern about recruiting qualified candidates to agree to run.

This argument is not especially persuasive on its own. Coffee observes that directors are often well-paid, for one.<sup>21</sup> More

19. Gold, *supra*, footnote 2.

20. *Ibid.*

importantly, many (but not all) of the objections to special compensation arrangements turn on the idea that the dissident group promises to pay its nominees contingent on future events. It would be one thing for a hedge fund or other activist to promise a dissident nominee some cash up-front for agreeing to run; it is another thing for the hedge fund to have an ongoing financial relationship with the nominee that turns on the performance of the corporation over some finite period. Instead, the dissident group could offer a cash payment, perhaps a sizable one, to dissidents in order to recruit them without inviting the same concerns about perverse incentives.

Put another way, recruitment of candidates *per se* is not a reason to adopt the kinds of incentive arrangements that existed in the Agrium and Hess contests since equivalent cash payments up-front would not invite the same criticisms. But there is a reason related to recruitment that may help explain why the arrangements add value, and why incentive-pay is especially important in the proxy contest context.

There are many well-known obstacles to success for a dissident in a proxy contest, including cost, but perhaps the most important is the difficulty that the dissident faces in assuring shareholders of their competence to run the corporation.<sup>22</sup> It is one thing for a shareholder to advance a persuasive critique of incumbent management; it is another entirely to convince shareholders that the dissident nominees and/or their picks for executives will be able to implement successfully an alternative strategy. Shareholders have excellent information about incumbent management, and have only conjectures about the likely performance of the dissidents in a managerial role at the company.

There are several strategies to overcome, or more realistically, mitigate, the impediments to success posed by the informational advantages enjoyed by the incumbent. One tactic is for dissidents to nominate well-known individuals from the industry. Another clearly important strategy is for the dissident group to signal its own belief in its strategy by owning a significant block of shares.<sup>23</sup> If, for example, a dissident shareholder owns a block of shares

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21. Coffee, "Balanced Perspective", *supra*, footnote 16.

22. See, e.g., Lucian Bebchuk and Oliver Hart, "Takeover Bids vs. Proxy Fights in Contests for Corporate Control", National Bureau of Economic Research Working Paper 8633 (Cambridge, Massachusetts, December, 2001), online: <<http://www.nber.org/papers/w8633>>.

23. See Fasken Martineau, *supra*, footnote 1, for recent discussion of dissident shareholdings and success rates.

worth \$1 billion under current management, it stands to lose a great deal if it assumes management and does a poor job; conversely, it stands to gain significantly if it does a good job.

The special compensation arrangements struck between dissident shareholders and their nominees may play a similar role to dissident shareholdings in signalling to shareholders the dissident nominees' confidence in their ability to manage the business. Consider two alternative ways that nominees could be paid for their time and effort, either a fixed fee or incentive pay based on stock-price appreciation; and consider two kinds of dissident nominees, those who are confident in their ability to add value, and those that are not. The different kinds of dissident nominees will have different views on the compensation package that is better for them. Confident nominees will be happy to be paid on the basis of performance, while less confident nominees would prefer to be paid on a fixed-fee basis. Special compensation arrangements based on performance therefore allow nominee directors in essence to put their money where their mouths are, and thus signal their confidence in their ability to guide the company going forward.

To be sure, other shareholders may come to the conclusion that the nominees are overconfident in their abilities, or that incumbent management could perform even better. Nominee self-belief is not perfectly correlated with ability. But just as owning a block of shares helps a dissident shareholder signal its ability, so too do special compensation arrangements help dissident nominees signal their ability.

The signalling justification, not the incentive justification, for special compensation arrangements provides a coherent justification for treating dissident nominees differently from incumbents with respect to compensation. Incumbents may benefit from the incentives that variable pay produce, but incumbents do not have the same need to convey information about themselves to shareholders; incumbents are known quantities, while the same cannot be said of dissident nominees. Dissident nominees face a greater need to signal ability than incumbents, and special compensation arrangements allow them to signal.

It is worth noting that there are alternatives to special arrangements for nominees to signal their confidence in their ability, but they are typically not as effective. For example, the nominees could themselves purchase shares in the target company. This occurs, at least indirectly, often. The principals in dissident

hedge funds typically invest in their funds, which implies a personal financial stake in the target company. But there are advantages to special arrangements over such alternatives. For one thing, the nominees may not have sufficient wealth to allow them to invest significantly in the target company. For another, an investment in shares today does not necessarily imply an investment tomorrow in shares. The nominees could simply sell their shares in the near term, which may either diminish their incentives to cause the corporation to increase value, or may create incentives to make short-run decisions. Special compensation arrangements, in contrast, result from contracts with the dissident shareholder group. The terms of the arrangements have been disclosed<sup>24</sup> and would not be easy to change. The commitment associated with the arrangements better allows the nominees to signal confidence than self-created alternatives.

In conclusion, not only do special arrangements create potentially valuable incentives for nominee directors, they allow the nominees to signal their ability. Such signalling is especially important for dissidents relative to incumbents, and helps justify incentive pay for dissident nominees that is not extended to incumbents.

## 2. Independence

The Agrium board described the special arrangements proposed in that contest for dissident nominees as “golden leashes”, the implication being that the nominee directors would be beholden to Jana because of them. Coffee also suggests that independence is a concern with such arrangements.<sup>25</sup> For example, he takes the position that directors who are paid pursuant to such arrangements should not be treated as independent directors for the purpose of determining audit committee composition. Again, the implication is that the special arrangements cast doubt on the capacity of the nominee directors to act in a manner that is independent from their sponsors.<sup>26</sup>

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24. This was true in the Agrium and Hess cases. I discuss in the Conclusion whether such disclosure is legally required, and whether it should be.

25. Coffee, *supra*, “Balanced Perspective”, *supra*, footnote 16. See, also, Erlichman, *supra*, footnote 3, who also describes these arrangements as “golden leashes.”

26. As Anita Anand, “Good Governance and Shareholder Activism in Proxy Contests” (unpublished, 2013), points out, hedge fund representatives on boards have been treated as independent under Canadian law, apparently without controversy.

While it appears to be a common view that special arrangements affect the independence of nominee directors, there are good reasons to challenge such a position. It is helpful to begin with a counterfactual: the dissident nominees are not compensated for agreeing to participate in the contest, but agree to participate despite the costs of time and reputational risk because of the prospect of director fees in the future paid by the corporation and/or the non-pecuniary benefits of the directorship. Consider the dissident director's sense of independence. The director finds herself with a board appointment that she would not have without the sponsorship of the dissident. The appointment makes her better off, or she would not take the job. Aside from non-pecuniary benefits, she realizes director fees, which as Coffee points out have grown considerably in recent years,<sup>27</sup> on an ongoing basis.

Now suppose that the hedge fund that sponsored her originally has a particular view of what strategy the company should pursue. The director owes her position to the fund, and loses (or gains) little personally from pursuing the sponsor's view given that she does not necessarily have a stake in the success of the company. In these circumstances, it would not be surprising if the nominee director felt inclined to go along with the hedge fund's views. To be sure, she owes a fiduciary duty to the company, not to the hedge fund, and there are reputational reasons that would encourage a director to seek to maximize value, not satisfy a sponsor (though reputation may also include consideration of future sponsors). But she does not have an intrinsic financial stake in her decisions, and it would be natural to be drawn to support the views of the person who helped put you in the position to start with.

Now suppose that a nominee director has entered into a special compensation arrangement with a hedge fund that pays her on the basis of the stock price performance. It becomes clear that the hedge fund has a view as to the optimal direction of the company. The nominee will likely have feelings of loyalty to the sponsor for the reasons just set out, but the difference is that now the director has a stronger financial stake in the performance of the company than she would without a special arrangement in place. If she disagrees with the hedge fund's vision, she must weigh natural feelings of loyalty and reciprocity against personal financial gain from improved stock price performance. The presence of the special compensation arrangement, in other words, creates

27. Coffee, "Balanced Perspective" *supra*, footnote 16.

financial incentives that could drive a *wedge* between the nominee and the sponsor that would not exist in its absence. The arrangement better ensures that the director is committed to improving value, and lessens the probability that natural feelings of loyalty and reciprocity will dictate behaviour.

In summary, there are competing considerations. On the one hand, if a director has not entered special compensation arrangements, she does not feel beholden to the sponsor for these additional funds but will owe her job and thus her regular directors' fees (even if the corporation pays them) to the sponsor; moreover, she will have attenuated incentives to maximize value, making hewing to the wishes of the sponsor less personally costly. On the other hand, with special compensation arrangements, the director predictably earns more from her association with the hedge fund, which may increase her sense of loyalty to the sponsor; but payment turns on corporate performance, not on following the wishes of the hedge fund sponsor, which increases a sense of loyalty to the corporation. It is entirely conceivable that the arrangements enhance independence, not undermine it.

To be sure, it is plausible that certain compensation arrangements would have the potential to undermine independence. For example, suppose that a hedge fund promises to pay its directors a bonus depending on the subjective judgment of the fund about the director's performance over time. Such a compensation structure would not counterbalance the tendency to loyalty to the hedge fund sponsor, but would in fact strengthen such a tendency. It is not unreasonable to conclude that certain arrangements would raise concerns about independence depending on the details.

Perhaps to avoid such concerns, and perhaps also to enhance the signal of the nominees' confidence discussed above, the hedge funds that have adopted such practices recently have avoided such undefined commitments. Jana, for example, committed explicitly to compensate the directors based on the share price performance over a defined period of time. This arrangement, as noted, was likely to bolster independence, not undermine it.

The analysis of the conflicts of interest in existing commentary has often lacked nuance. Coffee offers the following analogy:<sup>28</sup>

In overview, the fundamental issue in third party payments to directors is whether any perceived shortfall in compensation justifies introducing a strong conflict of interest. By analogy, suppose it were clear that judges disliked hearing complex patent cases and often delayed deciding them.

28. Coffee, "Balanced Perspective", *supra*, footnote 16.

Would that justify a party in a patent case offering a “pay for performance” bonus to a judge hearing his case, where the party made clear that the bonus would be paid if there were a timely decision, regardless of the outcome. I suspect most of us would still consider that too close to a bribe to be tolerable.

This analogy assumes that different shareholders, dissidents and other shareholders, for example, are adverse in interest in the same way that parties to litigation are. This is misleading. Hedge funds invest in companies to realize value. This is entirely consistent with the objectives of other shareholders.

Just as there is ambiguity from a policy perspective over the incentives (and signals) sent by special compensation arrangements, there is some scope for reasonable disagreement over at least some forms of special arrangements and their impact on independence. But especially given that there is reason to suppose that the kinds of arrangements that have arisen in practice bolster independence in significant ways, there is no reason to establish by regulation or by by-law a prophylactic rule against the arrangements. Rather, if the arrangements create concerns about independence, and if shareholders are uneasy about this, they have the option to vote against the dissident nominees. (I take it as given that disclosure is made.)<sup>29</sup> Indeed, the incumbents’ digs about “golden leashes” may have been influential in the Agrium contest. Independence, however, does not provide a reason generally to ban special arrangements; it may in fact provide reason to favour them.

It is also worth noting that third-party compensation for directors is common. For example, private equity investors often pay their nominee directors at investee companies on the basis of the performance of the company. For instance, the director who is also an employee of the private equity firm may have her bonus depend in part on the success of the company. If unease about independence would support a legal prohibition of third-party compensation in the context of proxy contests, it is not clear why it is permissible, as it has been without apparent controversy, in other settings.

As a final observation on the threat of a conflict of interest and the role of the shareholders, consider the fact that corporate law generally acknowledges that shareholders are in a good position to evaluate conflicts, and to allow them. Under the Canada Business Corporations Act, for example, directors that face a very clear

29. See discussion in the Conclusion.

conflict of interest because they propose to enter into a self-dealing transaction with the corporation can have the conflict sanitized by seeking shareholder approval of the transaction.<sup>30</sup> If shareholders are capable of ratifying blatant conflicts of interest, there is no reason why they should be prevented from voting on a much more tenuous conflict associated with special compensation arrangements. A ban on the arrangements because of independence is inappropriate.

### 3. Balkanized Boards

The final central point of contention concerns the potential for special compensation arrangements to “balkanize” the board and create dysfunction.<sup>31</sup> The argument is that the arrangements would create divisions on the board that reduce its effectiveness. I consider the argument in this section, expressing scepticism that the divisions that the arrangements create are worthy of special concern. In fact, the kind of variation in compensation across directors that the arrangements create is ubiquitous in corporate practice, yet there are no calls for regulating unequal compensation in these other settings. Worries about board dysfunction do not create a reason to regulate special compensation arrangements.

Following a heated proxy contest in which some, but not all, directors come from a dissident slate, it is inevitable that there will be some tension in the boardroom.<sup>32</sup> Despite this tension, the evidence is clear that proxy contests tend to enhance corporate value.<sup>33</sup> The right question when considering balkanization and special arrangements is not whether there will be tension post-contest, but rather whether the special arrangements aggravate the tensions, tipping otherwise functional boards into dysfunction. It is not clear why they would. The arrangements that have been observed in practice increase the financial stakes that the dissident’s nominee has in the company. It is not clear why this would create tension between the different directors as a matter of theory, and as a matter of practice, if it did, there would be a raft of problems in a wide range of existing corporate governance frameworks. The argument about balkanization proves too much,

30. Canada Business Corporations Act, R.S.C. 1985, c. C-44, s. 120.

31. See, e.g., Lipton, *supra*, footnote 7.

32. Cunningham, *supra*, footnote 2.

33. For an early contribution to the literature on the question, see Peter Dodd and Jerold Warner, “On Corporate Governance: A Study of Proxy Contests” (1983), 11 *J. Financ. Econ.* 401.



and would invite regulation in far more settings than simply proxy contests.

Directors ought to view themselves as owing a duty to the corporation. While views would vary precisely on how this duty ought to influence behaviour in any given situation, it is not at all clear why paying some directors on the basis of increases in corporate value would create tensions across directors. Presumably all directors ought to be interested in increasing value. This does not mean that all directors would agree at all points in time about how best to achieve this goal, but it is hard to see why enhanced financial stakes for some directors but not others inherently creates tensions that result in a less effective board.

If it were the case that varying financial incentives across directors created conflict, there would hardly be a corporate board in North America that would not be subject to this concern. Consider the following. First, most boards of public companies comprise both inside and outside directors. While outside directors may well be paid to some extent on the basis of the performance of the company, many are simply paid in cash, and in any event inside executives are much more likely to gain, and lose, personally with the financial performance of the business than outside directors. They are better paid than outside directors for their service to the corporation, and will often have a greater percentage of their pay based on performance than outside directors. Put another way, it would be a most unusual board that paid both inside and outside directors in a manner that equated financial stakes in the performance of the company across directors.

There is no evidence of which I am aware that indicates that greater incentive pay for inside than outside directors creates dysfunctional boards because of balkanization, nor am I aware of any calls to regulate such differences across directors. There may of course be tensions between inside and outside directors, especially when it comes to personnel questions, but such tensions do not inevitably lead to board dysfunction.

Now consider the relationship between outside directors themselves. There are a host of reasons to expect there to be significant variation across directors in the personal financial stakes that each has in the company. For one, there could well be variation in the shares that each chooses to buy on their own account. Some directors may have more wealth than others, which in turn allows them prudently to buy a larger absolute stake in the company. Director compensation structures could also result in

variation even if all directors are paid the same on an annual basis. New directors, for example, may not hold any stock, while long-tenured directors may hold stock that they have earned from their past service. Controlling shareholders may sit on the board of directors, which obviously implies a greater financial stake in the company for some directors than other directors. For these and other reasons, it would be a rare board in which all non-management directors have the same financial stakes in the company. Yet, again, I have yet to hear of evidence that these variations result in balkanization and dysfunction, nor have I heard commentary insisting that all directors have the same financial stakes in the corporation. Directors may have different financial interests without creating unhealthy divisions.

As another example of how the kinds of variation across directors that special compensation structures cause are seemingly commonplace and uncontroversial, consider practices in private equity. Private equity funds, when taking a stake in an investee company, typically place employees of the funds on the board, along with outside directors without an employment relationship with the fund.<sup>34</sup> The funds' representatives on the boards are very likely to be paid by the funds in significant part on the basis of the success of the investments for which the employee is responsible. The more financially successful the investment in the company, the greater the profits of the fund, and the greater the bonus of the employee. Such a strong financial incentive is much less likely to exist for outside directors not connected with the private equity fund.

The private equity example is perhaps the most closely analogous case to the special compensation arrangements proposed in connection with proxy contests. First, director compensation varies significantly across directors: in the case of proxy contests, the dissident nominees have greater financial stakes in the performance of the company as compared to the incumbents; in the private equity case, fund employees are likely to have greater financial stakes in the business than outside directors. Second, the source of the variation comes not from the company itself, but rather from a key shareholder in the company: in the case of proxy contests, the dissident shareholder promises to pay the directors; in the case of private equity, the private equity fund promises to pay its employees bonuses contingent on the performance of the

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34. Along with executive management of the company, but the distinction between executive directors and outside directors was discussed already.

company. Indeed, in some private equity contexts, the employee of the fund may not receive any compensation from the company itself, and may instead be paid exclusively by the fund. Onex Corp., a publicly traded private equity player, typically adopts such a compensation policy.<sup>35</sup>

Given how closely analogous the private equity and the special compensation arrangements are, it is striking that there is no commentary of which I am aware calling for regulation that would restrict a private equity fund from paying bonuses to its employees who sit on its investee companies' boards.

Some might respond to this analogy by noting that private equity funds typically do not invest in public companies, at least companies that remain public after the initial investment. In contrast, the special compensation arrangements almost by definition arise at public companies since this is the most likely setting for a heated proxy battle. Such a response would miss the point of the analogy for the present discussion. The point is that the practice of having a shareholder, not the company, pay directors directly in a manner that creates potentially stark variation across shareholders in financial incentives seems to be commonplace without apparent balkanization of boards in the private equity context. Why should we expect such a closely analogous practice to create or aggravate divisions in the proxy contest setting?

In any event, the fact that private equity funds may rarely be shareholders of public companies does not mean that there are not minority investors in investee companies. Onex, for example, has a policy of owning control of the companies in which it invests, but there are minority shareholders as well.<sup>36</sup> There therefore will often be divisions across shareholders, and would be concerns amongst the minority if the fund's practice of paying its directors created conflicts and dysfunction within the board. Unless there is

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35. See, for example, Onex C.E.O. Gerry Schwartz on the Celestica Board, available at Celestica, <[http://www.celestica.com/uploadedFiles/About\\_Us/Direc\\_Comp.pdf](http://www.celestica.com/uploadedFiles/About_Us/Direc_Comp.pdf)>, or Robert LeBlanc on the Skilled Healthcare Group Board, United States Securities and Exchange Commission, "Schedule 14A: Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934" (Washington, D.C., 2011), available at <[http://www.barchart.com/plmodules/?module=secFilings&popup=1&filingid=8524456&type=HTML&override=1&symbol=SKH#PROXY2012\\_HTM\\_S5934935AF85D56EE8F83EA41-DA875254](http://www.barchart.com/plmodules/?module=secFilings&popup=1&filingid=8524456&type=HTML&override=1&symbol=SKH#PROXY2012_HTM_S5934935AF85D56EE8F83EA41-DA875254)>.

36. Onex 2012 Annual Report, "Management's Discussion and Analysis and Financial Statements" (Toronto, December 31, 2012), online: <<http://www.onex.com/Assets/Downloads/2012%20Onex%20Annual%20ReportFeb.pdf>>.

regulation of this common practice, it is hard to see why there ought to be a rule against special compensation arrangements in proxy contests.

Finally, consider a case like Agrium even if Jana were banned from establishing special compensation arrangements. One of Jana's nominees was its founder, Barry Rosenstein. His personal wealth would be impacted significantly by the performance of Agrium had the proxy contest been successful — the value of his personal investment in the fund would depend in part on how Agrium performed. Rosenstein had an interest in how Jana's Agrium shares performed even if special compensation arrangements were unavailable. It is not unusual at all for hedge fund employees to be director nominees in proxy contests, and thus not unusual for at least some of the dissident nominees to realize financial benefits from the hedge fund sponsor and not from the corporation. Yet proposals to ban special compensation arrangements would not address these situations, thus implicitly acknowledge that outside compensation is not *per se* problematic. Even Lipton, who proposed a by-law amendment for corporations to consider that would ban most special arrangements, proposed a carve-out that would have allowed dissident nominees to benefit financially from their participation in a proxy contest because of their employment with the sponsor dissident.<sup>37</sup> It is not clear why Lipton would accept such a carve-out if outside compensation were problematic *per se*; and if it is not problematic *per se*, why not leave it to the shareholders to decide in any given case?

It would be a mistake, of course, to advance the proposition that balkanization of a board following a heated proxy contest is not a risk. The animus inherent in such contests could well contaminate future boards and impede their functioning. This is a risk that shareholders should take very seriously when deciding how to vote. But such a risk does not invite regulations that prevent dissidents from putting forward only a minority of candidates for director positions, nor should it invite corporations to propose by-laws that would disallow such short slates. It follows that even if special compensation arrangements were to create or aggravate divisions on boards, it is not the case that such a risk should invite regulatory prohibitions, or restrictive by-laws. Rather, if share-

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37. Lipton, *supra*, footnote 7. His proposed by-law provides, in part, that:  
[A]ny pre-existing employment agreement a candidate has with his or her employer (not entered into in contemplation of the employer's investment in the Corporation or such employee's candidacy as a director), shall not be disqualifying under this bylaw.

holders are collectively concerned about balkanization that results from special compensation arrangements, just as they could be concerned about balkanization that might result from a short slate itself, they should vote against the dissident group. If dissidents that propose special compensation arrangements are consistently defeated, the market will eliminate them. Given that there are good reasons for the arrangements to exist, regulation should not interfere.

### III. CONCLUSION

This article has established two basic points. First, the advantages of special compensation arrangements are more significant than has been appreciated. Second, there is no justification for regulation that restricts shareholder choices over the arrangements.

On the first point, special compensation arrangements may well enhance directors' incentives, as has been noted, but the incentive-based structure of the arrangements also provide nominee directors with the opportunity to signal their confidence in their ability to enhance value at the target corporation. The more confident is the nominee, the more valuable is an incentive pay plan; hence more confident nominees will be more willing to accept incentive-laden pay rather than cash. The ability of the dissident group to signal their ability to manage the corporation is essential to a successful campaign, and special arrangements can assist on this dimension.

Another underappreciated implication of special compensation arrangements is that they may serve a valuable purpose by *enhancing* the independence of the dissident nominees from the sponsor. The nominee with special incentives in place has stronger incentives to maximize value, all things equal, than one without such incentives. With compensation schemes in place, there is a counterweight to the feelings of loyalty to the sponsor that might otherwise have greater influence over the nominee.

Finally, the ubiquity of variable director compensation in general, and indeed the ubiquity of third-party payers of director incentives, is also underappreciated, at least in some commentary. The fact that pay varies within boards, and that private equity and hedge fund sponsors pay their employee-directors on the basis of performance without apparent board dysfunction or calls for regulation, is instructive. It would be peculiar to allow such

common potential causes of board balkanization (and to permit the root cause in the proxy contest context: short slates), while forbidding only special compensation arrangements. More plausibly, the special compensation arrangements are themselves not especially threatening to the board's functioning, just as variable pay in other contexts is not.

This is not to say that special compensation arrangements come without any downside. They could provide undesirable incentives; they conceivably could undermine independence; and it is possible, one supposes, that balkanization could result. But even if the disadvantages are non-trivial, this then raises the question of the correct legal response. The answer is the second point: there should not be a prophylactic approach, but rather shareholders should decide on their own in any given contest whether a dissident slate with special compensation is value-enhancing relative to the status quo. Proxy contests place the most fundamental question about a corporation's future, who will manage it, in the hands of shareholders. Corporate law entrusts many other fundamental questions, including whether to ratify a director's conflict of interest transaction, whether to merge, and whether to liquidate, to shareholders. It would be odd to ban a practice with significant potential upside, as well as potential dangers, rather than entrust it to the same body that passes judgment on these other fundamentally important questions.

In light of their (underappreciated) advantages, the potential dangers of special compensation arrangements do not justify a regulatory prohibition. To be sure, the argument in favour of leaving special compensation arrangements to shareholder voting tends to leave room for having shareholders vote on by-laws prohibiting such arrangements — again, if shareholders are to be trusted with proxy contests, there is a case for trusting them with voting on the by-law. The analysis here suggests, however, that shareholders ought not to support such a by-law. Better to retain the discretion to decide on a dissident slate and its proposed arrangements on a case-by-case basis.

The conclusion that shareholders ought to have discretion to vote for slates that rely on special compensation arrangements rests on a premise that shareholders have good information about the arrangements. As a matter of practice, this is a reasonable premise; both Hess and Agrium disclosed their arrangements. Moreover, there is good reason to conclude that such disclosure is required under Canadian securities law. Before examining the most

relevant regulatory provision, other requirements provide useful context. Form 51-102F5, which relates to the Canadian Securities Administrators' National Instrument 51-102, requires prospective directors to disclose their beneficial ownership, direct or indirect, in the company's securities. This does not necessarily cover the kind of contingent compensation that hedge funds may offer their nominees, but clearly supports the disclosure of interests that may influence the director's incentives. Form 51-102F6 requires disclosure of director compensation by the company and its subsidiaries, which also does not cover compensation related to the office paid for by third parties, but again evinces a regulatory push to publicize compensation arrangements. The most on-point regulation is Item 7.3 of Form 51-102F5, which provides:

If any proposed director is to be elected under any arrangement or understanding between the proposed director and any other person or company, except the directors and executive officers of the issuer acting solely in such capacity, name the other person or company and describe briefly the arrangement or understanding.

If special compensation arrangements are arrangements "under" which nominees would be elected, Item 7.3 requires their disclosure.

The language of Item 7.3 is not crystal clear. What, exactly, is an arrangement under which a nominee is nominated? In answering this question, it is noteworthy that controlling shareholders have not necessarily disclosed the terms of employment that relate to their nominees for board positions under Item 7.3. For example, in its 2013 Management Information Circular, Celestica stated that, "There are no contracts, arrangements or understandings between any director or executive officer or any other person pursuant to which any one of the nominees has been nominated."<sup>38</sup> Gerald Schwartz, the President and C.E.O. of Celestica's controlling shareholder, Onex, is a director on the Celestica board. Schwartz' compensation at Onex would presumably fluctuate at least in part (perhaps only in small part) on the basis of the performance of Celestica, and his nomination to the board is presumably not unrelated to his position at Onex. Yet Celestica apparently did not regard Item 7.3 as requiring disclosure of these arrangements.

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38. See Celestica, "Notice of Meeting and Management Information Circular" (Toronto, Merrill Corporation Canada, Filed March 15, 2013), online: System for Electronic Document Analysis and Retrieval (SEDAR) <<http://www.sedar.com/DisplayCompanyDocuments.do?lang=EN&issuerNo=00010284>>.

I do not express a final view about whether such arrangements ought to be disclosed in general; in principle there may be a legal argument that they ought to, but in an uncontested election, it is not clear how much this would matter. I do, however, believe that special compensation arrangements for nominees in the context of a proxy contest ought to be disclosed. As discussed, there are ambiguities about the desirability of special compensation arrangements such that an informed vote in a proxy contest requires such disclosure. Especially in light of the requirements to disclose beneficial ownership interests, and to disclose director compensation generally, both of which support a conclusion that disclosure of sources of incentives on prospective directors is appropriate, it is reasonable to read Item 7.3 as requiring disclosure of the basics of any special compensation arrangement.

There is a potential caveat. The securities disclosure regime is premised on the idea that mandatory disclosure is either necessary, or at the least, valuable, in promoting efficient markets and good corporate decision-making. This premise is, however, contestable, given that in the absence of *mandatory* rules, there will nevertheless be market pressure on corporations to disclose information voluntarily.<sup>39</sup> Whatever the debate as a matter of principle, it is clear that the law does not rest on such a belief, and rather mandates disclosure of relevant information. In such a context, it is appropriate, in my view, for regulators in Canada to have adopted legal rules that require disclosure of special compensation arrangements in proxy contests. In the presence of such disclosure, the case for simply relying on shareholder voting itself to regulate special arrangements is especially strong.

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39. See, *e.g.*, discussion in Frank Easterbrook and Daniel Fischel, "Mandatory Disclosure and the Protection of Investors" (1984), 70 *Virginia L. Rev.* 669.