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Activist Investing

Can Activist Hedge Fund Managers Provide Special Compensation to Nominees That Are Elected to the Board of a Target? An Interview with Marc Weingarten, Co-Head of the Global Shareholder Activism Practice at Schulte Roth & Zabel

By Jennifer Banzaca

Activist hedge fund managers typically seek to implement their ideas at a target company by nominating new directors and advocating for the election of those nominees. Such nominees are more likely to be elected – and, once elected, are more likely to be effective in implementing the activist's ideas – if they are better qualified, or, to use the activist term of art, if they are "rock stars." Accordingly, activists have asked how they can find rock star nominees and get the best performance out of those nominees if they are elected as directors.

At least two prominent hedge fund managers have answered this question by offering special compensation to nominees that are elected to the target board. These managers and their supporters argue that such compensation arrangements align the incentives of activist nominees and shareholders. Opponents argue that such special compensation arrangements engender short term thinking and result in dysfunctional boards.

To clarify the mechanics of such arrangements and to assess the merits of the arguments on either side of this debate – a debate that has real consequences for the rapidly growing volume of assets in activist hedge funds – The Hedge Fund Law Report recently interviewed Marc Weingarten, co-head (with David E. Rosewater) of the global shareholder activism practice at Schulte Roth & Zabel. (On April 22, Schulte announced the expansion of that practice into the U.K.) Our interview covered, among other things: the "market" for director compensation; structuring of special compensation of nominees by activists (including caps, the identity of the obligor and clawbacks); disclosure of such arrangements; the chief arguments for and against such arrangements; case studies involving the two managers referenced above; and the conflicting views of a prominent proxy adviser and law firm on a bylaw recommended by the law firm to prohibit compensation by shareholders of board nominees.

HFLR: Implicit in the nomination of a slate of directors in a proxy contest is the idea that the dissident slate would do a better job than the directors they would replace. To do a better job, the dissident slate must be well-qualified, and well-qualified people don't work for free. Thus, even absent so-called "special" compensation arrangements, there must be some standard or "market" baseline compensation arrangements for dissident directors. What is that baseline, in terms of compensation numbers and structures?

Weingarten: Board members get paid by the company whose board they are a part of. There is typically no other special compensation. It's usually either a fixed cash amount – generally in the range of $75,000 to $125,000 – stock options or stock grants, or a combination thereof. They receive this compensation for every year they serve on the board. With the stock options or grants, there is usually a vesting provision for a certain time period to serve on the board, sometimes three years.

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HFLR: How do the special or "incentive" compensation structures offered by activist hedge funds to their director nominees modify the standard director compensation arrangements? [For a discussion of incentive compensation in the hedge fund context generally, see "Use by Hedge Fund Managers of Profits Interests and Other Equity Stakes for Incentive Compensation," The Hedge Fund Law Report, Vol. 7, No. 15 (Apr. 18, 2014).] In particular: (a) Do the special compensation arrangements typically vary depending on whether or not a nominee is elected?; (b) Is the incentive component typically based on movement in the target's stock price, the fund's net profit from the investment or some other metric?; and (c) What is the typical duration of such incentive arrangements?

Weingarten: More often than not, there is no special compensation. In many cases, activists don't compensate their nominees at all. What I have seen is activists paying their board nominees, say, $50,000 for serving as nominees, whether or not they are elected. There is no additional compensation once the nominee is on the board. They also get indemnified in case they get sued for serving as a nominee. In a couple of cases last year – Jana in Agrium and Elliott in Hess – there were special compensation arrangements with their nominees to pay them additional amounts after those nominees got on the board. In the case of Hess and Elliott, they offered to pay their nominees the standard $50,000 nominee fee plus $30,000 for every percentage point that the company's stock outperformed its competitors over a three-year period. That payment was capped at $300,000. With Agrium and Jana, Jana agreed to pay its nominees a percentage of the profits the firm made on its Agrium shares over a three-year period.

These turned out to be very controversial compensation agreements. Managers feel these payments are necessary to attract the best possible candidates to be nominees to and serve on the board. A fairly typical board member, and activist nominee, is a retired former executive in the same industry as the target company, or a retired professional with appropriate skills. The base compensation they get for being a director at a public company is sufficient to attract them. To get a "rock star" nominee, usually those people are pretty wealthy and wouldn't be attracted by the standard board compensation, so managers offer additional incentives to serve as a nominee and to serve on the board. Where the nominee is receiving a one-time fee as special compensation, that is paid regardless of whether the nominee is actually elected to the board or not.

There haven't been, in recent years, all that many examples of significant incentive compensation payments from an activist to its board nominees to get elected. Historically, this is something that wasn't all that uncommon. Often the activists would pay their nominees, if they were elected to the board, a percentage of the profits the activist made in the stock of that company.

HFLR: Are such special compensation arrangements typically capped, or can nominees that are elected theoretically earn an amount with no upper limit for their service as directors?

Weingarten: I think it depends on the activist and the nominee. In the Elliott deal with their nominees for the Hess board, there was a cap but with Jana and Agrium, there was no cap. But keep in mind that with stock options or stock grants in standard board compensation, there is no cap either. If the stock goes up astronomically, that stock can be worth a great deal of money.

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HFLR: In the case of such special compensation arrangements, who typically pays the nominee or, if elected, the director – the hedge fund that made the investment in the target company or the management company that manages the fund that made the investment in the target?

Weingarten: It's effectively the hedge fund itself. It's considered a cost of the investment.

HFLR: Do special compensation arrangements typically offer only upside to nominees, or do they also typically provide for clawbacks of compensation in the event of a decline in the stock price or other adverse outcomes?

Weingarten: I have not seen the use of clawbacks in these special compensation agreements.

HFLR: Are hedge fund managers required to disclose such special compensation arrangements? If so, how and where?

Weingarten: Yes. Most companies have advance notification bylaws stating that if you intend to nominate directors, you have to send in notice to the company in advance and disclose information to the company about your nominees and your arrangements with those nominees. If you have any arrangement to pay the nominee, you have to disclose it to the company. Ultimately, if you run a proxy contest, your proxy materials would have to disclose those compensation arrangements as well.

HFLR: Is there any data reliably correlating such special director compensation arrangements to improved performance of the target company?

Weingarten: I don't think there's been any such analysis for activist-paid directors.

HFLR: One of the chief arguments against special nominee compensation arrangements is that they engender "short-termism" on the part of nominees that are elected. Elliott Management reportedly responded to this concern by noting that the term of the compensation arrangement it offered to nominees to the Hess board was "longer than any compensation offered by Hess," thus aligning the interests of nominees and long-term shareholders. Does special director compensation engender short-termism?

Weingarten: That is certainly not the case with the one-time payments. Those are payments simply for being a nominee and have nothing to do with compensation once you're on the board and so there would be no effect on the director's conduct once on the board. And the Elliott-Jana type special compensation can be structured to be measured over a multiple year period, just like management incentive plans.

HFLR: Another argument against special nominee compensation is that it creates a multi-tiered and dysfunctional board in which the subclass compensated by the activist has different incentives from the subclass compensated by the company. Does special nominee compensation cause a misalignment of incentives among board members?

Weingarten: For special compensation when they are board members, as was done by Elliott and Jana, that was the argument companies made. I don't believe there is such misalignment. Directors on company boards always have different financial incentives. If they've been given stock options every year for their service on the board, as many of them are, one director many have been on the board for 10 years and have 10,000 stock options and got them when the price was much lower than it is today. When you compare that to another director who has only been on the board for a year and has only 1,000 options priced very close to market, that's a significant compensation mismatch and those people have different financial incentives. For a financial incentive where a board member gets paid more if the company does well, I think all directors should have that incentive.

HFLR: Have ISS, Glass Lewis or other influential proxy advisers opined on the legality or desirability, from a corporate governance perspective, of special compensation of director nominees?

Weingarten: I think it was ISS' view that such compensation arrangements should be fully disclosed but, ultimately, shareholders should decide if those arrangements were detrimental and if the directors were right for the position.

HFLR: In a strongly worded memorandum dated May 9, 2013, Wachtell, Lipton, Rosen & Katz recommended a broadly drafted bylaw that Delaware and other corporations could adopt to prohibit incentive compensation of board nominees (while permitting indemnification and reimbursement of out-of-pocket expenses of such nominees). Halliburton reportedly adopted such a bylaw in July 2013. Are you familiar with other examples of companies adopting such bylaws? If so, has any such bylaw been challenged in court, and – if it has – with what result?

Weingarten: Wachtell touted this new bylaw they urged companies to adopt which would prohibit any compensation from a shareholder who was nominating a director nominee. A bunch of companies adopted those bylaws. ISS came out with a recommendation that shareholders vote against directors on the nominating and governance committees of any company that adopted that bylaw. So, many of the companies that adopted that bylaw withdrew them in the face of ISS opposition. ISS felt the companies should have asked shareholders whether they agreed to this kind of bylaw, as opposed to just adopting it unilaterally. Most of those bylaws have since been withdrawn.

To my knowledge, the bylaw has not been challenged in court.