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Bylaw Protection against Dissident Director Conflict/Enrichment Schemes

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This year, the practice of activist hedge funds engaged in proxy contests offering special compensation schemes to their dissident director nominees has increased and become even more egregious. While the terms of these schemes vary, the general thrust is that, if elected, the dissident directors would receive large payments, in some cases in the millions of dollars, if the activist's desired goals are met within the specified near-term deadlines.

These special compensation arrangements pose a number of threats, including:

- undermining Board prerogatives to set director pay and select the timeframe over which corporate goals are to be achieved;
- creating a multi-tiered, dysfunctional Board in which a subset of directors are compensated and motivated significantly differently from other directors;
- creating 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;
- opening 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;
- creating 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
- introducing unnecessary and problematic complexity and conflicts in strategic reviews and calling into question those directors' ability to satisfy their fiduciary duties.

These arrangements have been justly criticized by leading commentators. Columbia School of Law Professor John C. Coffee, Jr. has written that “third-party bonuses create the wrong incentives, fragment the board and imply a shift toward both the short-term and higher risk.” Professor Stephen Bainbridge of UCLA has concurred, saying “if this nonsense is not illegal, it ought to be.”

In order to proactively address the threats posed by such schemes to the integrity of the boardroom and board decision-making processes, companies should consider adopting a bylaw that would disqualify candidates that are party to any such arrangements from serving as directors.

Here is a bylaw formulation we recommend:

> “No person shall qualify for service as a director of the Corporation if he or she is a party to any compensatory, payment or other financial agreement, arrangement or understanding with any person or entity other than the Corporation, or has received any such compensation or other payment from any person or entity other than the Corporation, in each case in connection with candidacy or service as a director of the Corporation; *provided* that agreements providing only for indemnification and/or reimbursement of out-of-pocket expenses in connection with candidacy as a director (but not, for the avoidance of doubt, in connection with service as a director) and any pre-existing employment agreement a candidate has with his or her employer (not entered into in contemplation of the employer’s investment in the Corporation or such employee’s candidacy as a director), shall not be disqualifying under this bylaw.”

The board of directors of a Delaware corporation can adopt this bylaw under the authority of Section 141(b) of the Delaware General Corporation Law which provides that “the certificate of incorporation or bylaws may prescribe other qualifications for directors”. Most other states’ corporation laws have comparable provisions. Adoption of such a bylaw should be a simple matter of the board’s business judgment. Even if tested under an enhanced reasonableness standard, it should withstand scrutiny as a measured response to the threat posed by these inappropriate schemes. Adopting this bylaw would not prevent an activist from nominating candidates, reimbursing their expenses and indemnifying them in connection with the solicitation, or from providing customary compensation to nominees for their efforts if they are not elected (if they are elected they would normally receive director compensation as fixed by the Board). Nor does the bylaw disqualify a principal or employee of the nominating hedge fund (or other nominating shareholder) from director service on account of the fact that his or her compensation from the fund may depend in part on the price of target company shares owned by the fund.

The threats posed to board and corporate effectiveness by short-term oriented activist hedge funds are serious enough without having to worry about a subset of directors being compensated and motivated differently from the rest, and having misaligned incentives. We believe that corporations can and should act to proactively preclude these inappropriate arrangements.