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ISS Publishes Guidance on Director Compensation (and Other Qualification) Bylaws

In the latest instance of proxy advisors establishing a governance standard without offering evidence that it will improve corporate governance or corporate performance, ISS has <u>adopted a</u> <u>new policy position</u> that appears designed to chill board efforts to protect against "golden leash" incentive bonus schemes. These bonus schemes have been used by some activist hedge funds to recruit director candidates to stand for election in support of whatever business strategy the fund seeks to impose on a company.

In its new FAQ, ISS warns that if a board adopts "restrictive director qualification bylaws" designed to prohibit "golden leashes" without submitting them to a shareholder vote, ISS "may" recommend a withhold vote against director nominees "for material failures of governance, stewardship, risk oversight, or fiduciary responsibilities." The references to fiduciary responsibilities, risk oversight and governance are particularly ironic given the <u>serious risks</u> that such "golden leash" arrangements pose to fiduciary decision-making and board functioning, including the risks of conflicted directors, fragmented and dysfunctional boards and short-termist behavior, which ISS regrettably does not address or even acknowledge. The ISS FAQ position is consistent with the ISS November recommendation (previously discussed <u>here</u>) that shareholders withhold votes from director candidates of a small-cap bank holding company because the board adopted a director compensation bylaw without shareholder approval. The directors of that company were reelected but the ISS recommendation drove a significant withhold vote.

In light of ISS' threat that it may issue withhold vote recommendations against boards that adopt director compensation bylaws, it can be expected that many companies will decide that discretion is the better part of valor and avoid a confrontation with ISS, despite the risks posed by "golden leash" schemes. This would be a rational response given the hopefully low probability for any company of actually having to deal with this issue, the fact that "golden leash" arrangements taint dissident candidates and can be used against them in proxy contests, and the prospect that the courts may step in to address the conflicts of interest and duty of loyalty problems created by such schemes.

Some companies may still wish to protect themselves from the threats posed by "golden leash" arrangements through appropriate bylaws and in that case may wish to consider bylaws that permit payment of a reasonable one-time candidacy fee. At a minimum, all companies should require full disclosure of any third-party arrangements that director candidates may have, which has long been a common practice and does not (at least given ISS' current position) raise the risk of an ISS withhold recommendation. Companies that do choose to adopt such protective bylaws, with or without a shareholder vote, should consider appropriate shareholder outreach and engagement, focusing on the importance of discouraging third-party incentive compensation arrangements that may lead to board conflicts and divergent incentives, which the Council of Institutional Investors has noted "blatantly contradicts" its policies on director compensation.

> Martin Lipton Andrew R. Brownstein Steven A. Rosenblum Trevor S. Norwitz David C. Karp Sabastian V. Niles

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