

From the Public Company Advisory Group of Weil, Gotshal & Manges LLP

March 1, 2017

Heads Up for the 2017 Proxy Season: Tackle Director Vulnerabilities for Re-Election

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Taking stock of directors' vulnerabilities to a negative voting recommendation from ISS is important when putting the last touches on this year's annual meeting proxy statement and planning for shareholder engagement about the annual meeting.

The 2016 proxy season saw a small uptick in the number of directors failing to receive majority shareholder support (46 directors at 26 companies, compared to 39 directors at 23 companies in 2015¹). All told, ISS recommended voting against or withhold from individual directors over 3000 times at Russell 3000 companies.

Lack of board responsiveness to shareholder proposals or other governance issues, poor meeting attendance, non-independent members on key committees, "overboarded" directors, audit controversies and unilateral board actions impacting shareholder rights were the predominant reasons for a negative ISS recommendation.

While a negative recommendation from ISS may not result in a failure to receive sufficient votes to be elected, negative attention, investor criticism and reputational issues are sufficient reasons for companies and their directors to understand the circumstances in which ISS may recommend voting against a director.

We summarize below the broad range of circumstances in which ISS indicates it may issue a negative voting recommendation against individual directors, committee members, or the entire board. For 2017, ISS added or revised considerations relating to overboarding, unilateral charter / bylaw amendments, and restrictions on binding shareholder proposals. These recent updates are noted in *italics* below.

The circumstances are organized based on the ISS QualityScore pillars: board governance, shareholder rights, compensation, and audit and risk oversight. For additional information, see the ISS voting policies, including relevant FAQs, available [here](#).

What To Do Now?

● **Identify Vulnerabilities**

- Become familiar with ISS's voting policies that may affect director elections.
- Consider whether and how the company has implemented a majority-supported shareholder proposal (including proxy access).
- Check director attendance records and review proxy statement disclosure required by Item 407(b) of Regulation S-K. ISS will consider a director's medical issues or family emergencies, so if there is a good reason for a directors' poor attendance ensure that appropriate disclosure is provided.
- Review ISS's prior assessment of director independence and whether ISS views a particular director to be an "independent outside director," "affiliated outside director," or "inside director," as per ISS's categorization of directors.
- Re-assess director "overboarding" status under the new ISS thresholds for 2017 meetings. For a description of the ISS (and Glass Lewis) new overboarding policies, see our alert, available [here](#).
- Consider the outcome of last year's say-on-pay vote. If the company received less than 70% of the votes cast in support of last year's say-on-pay proposal, ensure that proxy statement disclosure clearly discusses shareholder engagement efforts on the issues that contributed to the low level of support and any subsequent changes to compensation structure.
- Consider any controversies that occurred regarding the company's financial statements and the audit.
- Consider if the board implemented any unilateral charter or bylaw amendments that adversely affect shareholder rights.
 - Newly public companies in particular should consider whether the board adopted a bylaw or charter provision in connection with the IPO that ISS views as materially adverse to shareholders rights (such as a classified board and supermajority voting provisions) or has adopted a multi-class capital structure.
- Consider whether the company's charter imposes undue restrictions on shareholders' ability to amend the bylaws.
 - ISS has specifically highlighted that over two-thirds of Maryland REITs have taken advantage of a provision in Maryland law that permits the company to confer the power to amend the bylaws exclusively on the board.

● **Enhance Disclosure**

- Enhance proxy disclosure to address the circumstances that could lead to a negative recommendation.
- Clearly describe the board's rationale for its decisions on compensation and other matters, particularly where the company's policies do not conform to ISS's policies.

● **Engage Shareholders**

- Engage with shareholders to explain the company's position and garner support.
- Be mindful of requirements regarding proxy solicitation and delivery of proxy materials under Rule 14a-3.



Circumstance	ISS Policy	Targeted Directors
Board Governance		
Governance Failures	<ul style="list-style-type: none"> ● Material failures of governance, stewardship, risk oversight (examples include bribery, large or serial fines or sanctions from regulatory bodies, significant adverse legal judgments or settlements, hedging of company stock, or significant pledging of company stock), or fiduciary responsibilities at the company ● Failure to replace management as appropriate ● Egregious actions related to service on other boards that raise substantial doubt about the director’s ability to effectively oversee management and serve the best interests of shareholders at any company 	Entire Board, Committee Members, or Individual Director
Responsiveness to Shareholder Proposals	<ul style="list-style-type: none"> ● The board failed to act on a shareholder proposal that received approval by a majority of votes cast in the previous year. Factors that will be considered are: <ul style="list-style-type: none"> ● Disclosed outreach efforts by the board to shareholders in the wake of the vote ● The board’s rationale, as provided in the proxy statement, for the level of implementation of the proposal ● Subject matter of the proposal ● Level of support for and opposition to the proposal at past meetings ● Board actions in response to the majority vote and its shareholder engagement ● Continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals) ● Other factors as appropriate 	Entire Board, Committee Members, or Individual Director
Responsiveness to Shareholder Proposal on Proxy Access	<ul style="list-style-type: none"> ● May issue an adverse recommendation if a proxy access policy implemented or proposed by management contains material restrictions more stringent than those included in a majority-supported proxy access shareholder proposal with respect to the following, at a minimum: <ul style="list-style-type: none"> ● Ownership thresholds above three percent ● Ownership duration longer than three years ● Aggregation limits below 20 shareholders ● Cap on nominees below 20 percent of the board 	Entire Board, Committee Members, or Individual Director
>50% Negative Votes Against Director	<ul style="list-style-type: none"> ● At the previous board election, any director received more than 50 percent withhold/against votes of the shares cast and the company failed to address the underlying issue(s) that caused the high withhold/against votes 	Entire Board, Committee Members, or Individual Director

Circumstance	ISS Policy	Targeted Directors
Takeover Offers	<ul style="list-style-type: none"> The board failed to act on takeover offers where a majority of shareholders tendered their shares 	Entire Board, Committee Members, or Individual Director
Say-on-Pay Frequency	<ul style="list-style-type: none"> The board implemented an advisory vote on executive compensation on a less frequent basis than the frequency that received the majority of votes cast at the most recent shareholder meeting at which shareholders voted on the say-on-pay frequency When no say-on-pay frequency received a majority and the board implements an advisory vote on executive compensation on a less frequent basis than the frequency that received a plurality of the votes cast at the most recent shareholder meeting at which shareholders voted on the say-on-pay frequency, taking into account: <ul style="list-style-type: none"> The board's rationale for selecting a frequency that is different from the frequency that received a plurality The company's ownership structure and vote results ISS's analysis of whether there are compensation concerns or a history of problematic compensation practices 	Entire Board, Committee Members, or Individual Director
Attendance	<ul style="list-style-type: none"> Attends less than 75 percent of board and committee meetings for the period of service (or missed more than one meeting, if the director's total service was three or fewer meetings), unless the absence was due to medical issues or family emergencies, and the reason for such absence is disclosed in the proxy statement or other SEC filing If the proxy disclosure is unclear and insufficient to determine whether the director attended at least 75 percent of board and committee meetings during the period of service 	Individual Director
"Overboarding"	<ul style="list-style-type: none"> <i>Sits on more than five public company boards, with boards of subsidiaries with publicly-traded stock counting as separate boards.</i> CEO of a public company and sits on boards of more than three public companies in total, with boards of subsidiaries with publicly-traded stock counting as separate boards. Although all of a CEO's subsidiary boards will be counted as separate boards, ISS will not recommend a withhold vote from the CEO of a parent company board or any of the controlled (> 50% ownership) subsidiaries of that parent, but may do so at subsidiaries that are less than 50% controlled and boards outside of the parent/subsidiary relationship. 	Individual Director
Independent Key Committees	<ul style="list-style-type: none"> An "inside director" or "affiliated outside director" (as separately defined by ISS) serving on the audit, compensation or nominating committee² 	Individual Director

Circumstance	ISS Policy	Targeted Directors
Lacking Key Board Committees	<ul style="list-style-type: none"> The company lacks an audit, compensation, or nominating committee so that the full board functions as that committee² 	All Inside Directors and Affiliated Outside Directors
Majority Independent Board	<ul style="list-style-type: none"> The full board is less than majority independent² 	All Inside Directors and Affiliated Outside Directors
Shareholder Rights		
Unilateral Bylaw/ Charter Amendments Diminishing Shareholder Rights	<ul style="list-style-type: none"> Board amendment of the company's bylaws or charter without shareholder approval/ratification in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders, considering the following factors, as applicable: <ul style="list-style-type: none"> The board's rationale for adopting the bylaw/charter amendment without shareholder approval or ratification Disclosure by the company of any significant engagement with shareholders regarding the amendment Level of impairment of shareholders' rights caused by the board's unilateral amendment to the bylaws/charter The board's track record with regard to unilateral board action on bylaw/charter amendments or other entrenchment provisions The company's ownership structure and existing governance provisions The timing of the board's amendment to the bylaws/charter in connection with a significant business development Other factors, as deemed appropriate, that may be relevant to determine the impact of the amendment on shareholders 	Entire Board, Committee Members, or Individual Director
Establishing Classified Board	<ul style="list-style-type: none"> Board amendment of the company's bylaws or charter without shareholder approval/ratification to establish a classified board 	Entire Board, Committee Members, or Individual Director
Establishing Supermajority	<ul style="list-style-type: none"> Board amendment of the company's bylaws or charter without shareholder approval/ratification to adopt a supermajority vote requirement to amend the charter or bylaws 	Entire Board, Committee Members, or Individual Director



Circumstance	ISS Policy	Targeted Directors
Eliminating Shareholder to Amend Bylaws	<ul style="list-style-type: none"> Board amendment of the company’s bylaws or charter without shareholder approval/ratification to eliminate shareholders’ ability to amend bylaws 	Entire Board, Committee Members, or Individual Director
Unilateral Bylaw/ Charter Amendments Prior to IPO	<ul style="list-style-type: none"> If prior to or in connection with the company’s initial public offering, the company adopts bylaw or charter provision adverse to shareholders’ rights, <i>or implemented a multi-class capital structure in which the classes have unequal voting rights</i>, considering the following factors: <ul style="list-style-type: none"> The level of impairment of shareholders’ rights The company’s or the board’s rationale The provision’s impact on the ability to change the governance structure (e.g., limitations on shareholders’ right to amend the bylaws or charter, or supermajority vote requirements to amend the bylaws or charter) <i>Any reasonable sunset provision</i> <i>Other relevant factors</i> 	Entire Board, Committee Members, or Individual Director
Board Accountability: Problematic Takeover Defenses with Problematic Governance Issue or Poor Performance	<ul style="list-style-type: none"> The board is classified and a continuing director responsible for a problematic governance issue at the board/committee level that would warrant a negative vote recommendation is not up for election (ISS may hold any or all appropriate nominees, except new nominees, accountable) The board lacks accountability and oversight, coupled with sustained poor performance of the company relative to peers measured by one-year and three-year total shareholder returns in the bottom half of a Russell 3000 company’s four-digit Global Industry Classification Group (ISS will consider “problematic” the following governance practices: a classified board structure, a supermajority vote requirement, a plurality vote standard in uncontested director elections or majority vote standard for director elections with no carve-out for contested elections, inability of shareholders to call special meetings or act by written consent, a dual-class capital structure, and/or a non-shareholder approved poison pill. ISS will also take into consideration the company’s five-year total shareholder return and operational metrics) 	Entire Board

Circumstance	ISS Policy	Targeted Directors
Poison Pills	<ul style="list-style-type: none"> ● A poison pill has a dead-hand or modified dead-hand feature, in which case a negative vote recommendation will be made every year until the feature is removed ● The board adopts a poison pill with a term of more than 12 months or renews any existing pill including a pill with a term of 12 months or less without shareholder approval (a commitment or policy that puts a newly adopted pill to a binding shareholder vote may potentially offset a negative vote recommendation) ● The company maintains a poison pill that was not approved by shareholders (ISS will review annually for companies with classified boards and at least once every three years for companies with declassified boards) ● The board makes a “material adverse change” to an existing poison pill without shareholder approval ● On a case-by-case basis: the board adopts a poison pill with a term of 12 months or less without shareholder approval, taking into account the following factors: <ul style="list-style-type: none"> ● The date of the pill’s adoption relative to the date of the next meeting of shareholders (whether the company had time to put the pill on the ballot for shareholder ratification given the circumstances) ● The company’s rationale ● The company’s governance structure and practices ● The company’s track record of accountability to shareholders 	Entire Board
<i>Restricting Binding Shareholder Proposals³</i>	<ul style="list-style-type: none"> ● <i>The charter imposes undue restrictions on shareholders’ ability to amend the bylaws. Restrictions include, but are not limited to:</i> <ul style="list-style-type: none"> ● <i>Outright prohibition on the submission of binding shareholder proposals</i> ● <i>Share ownership requirements or time holding requirements in excess of SEC Rule 14a-8</i> 	<i>Governance Committee Members</i>



Circumstance	ISS Policy	Targeted Directors
Compensation		
<p>< 70% Shareholder Support of Say-on-Pay</p>	<ul style="list-style-type: none"> ● On a case-by-case basis: the company’s previous say-on-pay proposal received the support of less than 70 percent of votes cast, taking into account: <ul style="list-style-type: none"> ● The company’s response, including: <ul style="list-style-type: none"> ○ Disclosure of engagement efforts with major institutional investors regarding the issues that contributed to the low level of support ○ Specific actions taken to address the issues that contributed to the low level of support ○ Other recent compensation actions taken by the company ● Whether the issues raised are recurring or isolated ● The company’s ownership structure ● Whether the support level was less than 50 percent, which would warrant the highest degree of responsiveness 	<p>Compensation Committee Members and Potentially Entire Board</p>
<p>Absence of Say-on-Pay Vote or Egregious Situations</p>	<ul style="list-style-type: none"> ● In the absence of a say-on-pay vote, or in egregious situations, if: <ul style="list-style-type: none"> ● There is a significant misalignment between CEO pay and company performance, considering: <ul style="list-style-type: none"> ○ Peer group alignment (total shareholder return and CEO’s total pay rank within a peer group as measured over one-year and three-year periods and considering the multiple of CEO total pay relative to the peer group median) ○ Absolute alignment (difference between the trend in annual CEO pay changes and the trend in annualized company total shareholder return over the prior five years) ○ Qualitative factors ● The board exhibits a significant level of poor communication and responsiveness to shareholders ● The company fails to submit one-time transfers of stock options to a shareholder vote ● The company fails to fulfill the terms of a burn rate commitment made to shareholders ● The company maintains significant “problematic pay practices,” such as: <ul style="list-style-type: none"> ○ Repricing or replacing of underwater stock options/SARS without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options) ○ Excessive perquisites or tax gross-ups, including any gross-up related to personal use of corporate aircraft, executive life insurance, 	<p>Compensation Committee Members and Potentially Entire Board</p>

Circumstance	ISS Policy	Targeted Directors
	<p>bonus, a secular trust or restricted stock vesting</p> <ul style="list-style-type: none"> ○ New or extended agreements that provide for: <ul style="list-style-type: none"> ● Change in control payments exceeding three times base salary plus bonus ● Change in control severance payments without involuntary job loss or substantial diminution of duties (“single” or “modified single” triggers) ● Change in control payments with excise tax gross-ups (including “modified” gross-ups) ● In the absence of a say-on-pay vote, ISS may also consider if the company has recently practiced or approved “problematic pay practices,” which include (in addition to those listed above): <ul style="list-style-type: none"> ● Egregious employment contracts (contracts containing multi-year guarantees for salary increases, non-performance based bonuses, and equity compensation) ● Overly generous new-hire package for new CEO (excessive “make-whole” provisions without sufficient rationale or any problematic pay practice) ● Abnormally large bonus payouts without justifiable performance linkage or proper disclosure (includes performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and the link to performance) ● Egregious pension/supplemental executive retirement plan payouts (inclusion of additional years of service not worked that result in significant benefits provided in new arrangements or inclusion of performance-based equity or other long-term awards in the pension calculation) ● Excessive perquisites, perquisites for former and/or retired executives (such as lifetime benefits, car allowances, personal use of corporate aircraft, or other inappropriate arrangements) or extraordinary relocation benefits (including home buyouts) ● Excessive severance and/or change in control provisions (change in control payment exceeding 3 times base salary, new or materially amended arrangements that provide for change-in-control payments without loss of job or substantial diminution of job duties) ● Excessive income tax reimbursements on executive perquisites or other payments ● Dividends or dividend equivalents paid on unvested performance shares or units ● Internal pay disparity (excessive differential between CEO total pay and that of next highest-paid named executive officer) 	

Circumstance	ISS Policy	Targeted Directors
	<ul style="list-style-type: none"> • Voluntary surrender of underwater options by executive officers (may be viewed as an indirect option repricing/exchange program especially if those cancelled options are returned to the equity plan, as they can be re-granted to executive officers at a lower exercise price, and/or the executives subsequently receive unscheduled grants in the future) • Insufficient executive compensation disclosure by externally managed issuers (EMIs) • Other pay practices deemed problematic but not covered in any of the above categories 	
Audit & Risk Oversight		
Problematic Audit-Related Practices	<ul style="list-style-type: none"> • On a case-by-case basis: poor accounting practices rising to a level of serious concern such as fraud, misapplication of GAAP, and material weaknesses identified in Section 404 disclosures are identified, taking into consideration the practices' severity, breadth, chronological sequence and, duration, and the company's efforts at remediation or corrective actions 	Entire Board
Excessive Audit Fees	<ul style="list-style-type: none"> • Non-audit fees paid to the auditor are excessive (e.g., non-audit fees are greater than audit fees plus audit-related fees plus tax compliance/preparation fees) 	Audit Committee Members
Adverse Opinion	<ul style="list-style-type: none"> • The company receives an adverse opinion on its financial statements from its auditor 	
Inappropriate Indemnifications	<ul style="list-style-type: none"> • There is persuasive evidence that the audit committee entered into an inappropriate indemnification agreement with its auditor that limits the ability of the company or its shareholders to pursue legitimate legal recourse against the audit firm 	Audit Committee Members
Other Audit Concerns	<ul style="list-style-type: none"> • On a case-by-case basis: poor accounting practices, which rise to a level of serious concern (such as fraud, misapplication of GAAP, and material weaknesses identified in Section 404 disclosures) are identified, taking into consideration the practices' severity, breadth, chronological sequence and, duration, and the company's efforts at remediation or corrective actions 	Audit Committee Members

ENDNOTES

- ¹ Data gathered from ISS Voting Analytics (available by subscription only). ISS Report: 2016 U.S. Proxy Season Review – Director Elections (October 21, 2016, available by subscription only).
- ² The ISS definitions of “independent outside director,” “inside director” and “affiliated outside director” are substantially different from the New York Stock Exchange or Nasdaq definitions of an independent director. “Controlled companies” availing themselves of the exemption from the listing requirements to have a majority of independent directors and independent compensation and nominating committees should be aware that ISS generally views directors affiliated with a significant shareholder as “affiliated outside directors” and will issue a negative recommendation against such directors that sit on any of the company’s key committees.
- ³ Maryland law, in particular, enables companies to provide in their charters that only the board, and not shareholders, have the right to amend the company’s bylaws. In its annual survey results, ISS highlighted that over two-thirds of Maryland REITs have taken advantage of this provision and conferred the power to amend the bylaws exclusively on the board. While the revised policy does not specifically address REITs, it appears as though Maryland REITs may be particularly implicated.

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