January 22, 2009

Corporate Governance Update: RiskMetrics Update Continues to Hamper Director Discretion

David A. Katz
and
Laura A. McIntosh*

RiskMetrics Group ("RMG"), formerly Institutional Shareholder Services, recently published 2009 updates to its domestic and international corporate governance policies, indicating how it will recommend that its clients vote on various matters for the next proxy season.[1] Because many institutional investors strictly adhere to RMG's voting recommendations, public companies are obliged to take note of the updated recommendations. "Withhold vote" recommendations (which now have considerable force given the prevalence of majority voting) clearly remain RMG's favored means of expressing disapproval of company policies. This year's policy updates continue RMG's trend of espousing policies that tend to shift corporate decision-making from boards of directors to shareholders, including activists and special interest groups. In particular, RMG's updated policies seek to further limit directors' discretion in areas traditionally within the board of directors' clear authority under state law, including executive compensation, corporate governance matters and social policy.[2]

Executive Compensation

In the current economic environment, executive compensation practices are subject to significant political and public scrutiny around the world.[3] RMG's policy

* David A. Katz is a partner at Wachtell, Lipton, Rosen & Katz. Laura A. McIntosh is a consulting attorney for the firm. David M. Adlerstein, an associate at the firm, contributed to this column. The views expressed are the authors' and do not necessarily represent the views of the partners of Wachtell, Lipton, Rosen & Katz or the firm as a whole.

[1] RiskMetrics Group, 2009 Corporate Governance Policy Updates and Process, Nov. 25, 2009 (available at www.riskmetrics.com/policy) ("RMG 2009 U.S. Updates").

[2] *See* RiskMetrics Group, 2009 U.S. Proxy Voting Guidelines Summary, Dec. 24, 2008 (available at www.riskmetrics.com/sites/default/files/RMG2009SummaryGuidelinesUnitedStates.pdf)

[3] Executive compensation is a high-profile issue in the European Union as well as in the United States. RMG significantly expanded its European compensation guidelines, in part to reflect recommended guidelines issued by the European Union Commission. *See* RiskMetrics Group 2009 International Corporate Governance Policy Updates, Nov. 25, 2008, at 13-15 (available at www.riskmetrics.com/sites/default/files/RMG2009PolicyUpdateInternational.pdf) ("RMG 2009 International Updates").

If your address changes or if you do not wish to continue receiving these memos, please send an e-mail to Publications@wlrk.com or call 212-403-1476.

W/1338542

updates focus heavily on what RMG considers "poor pay practices," a category RMG has expanded for 2009 to include new change-in-control arrangements that include "golden parachute" excise tax gross-ups, "walk away" rights providing for the payment of severance upon a voluntary resignation or "liberal" change-in-control definitions which could result in payments even though an actual change in control may not occur (*e.g.*, upon shareholder approval of a transaction); tax gross-ups on executive perks; and payments of dividends or dividend equivalents on unearned performance awards. Under RMG's updated policies, such practices now may trigger a withhold recommendation on compensation committee members, the CEO, or, in certain instances, the entire board of directors. Circumstances under which one or more "poor pay practices" will trigger a withhold recommendation remain unclear, and likely will be determined by RMG on a case-by-case basis. RMG also indicated that it will apply its voting recommendations to discourage companies from re-pricing stock options or resetting performance targets because of deterioration in market prices. Moreover, it appears likely that RMG will support shareholder proposals to "claw-back" bonus incentive compensation paid based on financial statements or other criteria that prove to be materially inaccurate, regardless of whether there is any fraud or wrongdoing. In addition, RMG now will recommend against proposals to adopt equity-based compensation plans providing for the "liberal" change-in-control definition combined with single-trigger acceleration of award vesting.[4]

Although RMG's updated compensation policies merit serious attention, directors must not lose sight of the critical need to attract and retain the highest quality executives in a competitive environment and the reason most companies provide for excise tax gross-ups: not as compensation, but to equalize payments for similarly situated executives who face disparate treatment under applicable tax regulations. Directors are increasingly likely to face difficult decisions regarding compensation practices that the market may require in order to retain talented individuals but which RMG finds offensive.

Director Performance Metrics

RMG has made significant revisions to the quantitative element of the performance framework it utilizes to evaluate directors, greatly increasing the potential frequency of "withhold vote" recommendations. RMG's policy is to recommend a "withhold vote" recommendation if a board "lacks accountability and oversight," coupled with "sustained poor performance" relative to the company's peers. For 2009, sustained poor performance will be measured by one- and three-year total shareholder returns in the bottom half of a company's industry group or the relevant index; previously, RMG considered recommending "withhold votes" from companies in the bottom 5 percent of

[4] RMG 2009 U.S. Updates at 22-31.

their peer groups, and also considered several operational metrics in quantifying performance. RMG now states that it also "may" consider a company's five-year total shareholder return and five-year operational metrics in its evaluations.[5] This revised "methodology" appears geared to be overly inclusive and focused on short-term results; it will be important to monitor whether RMG's clients blindly follow RMG's recommendations in this area or consider more subjective criteria on a company-by-company basis.

On the international front, RMG has updated its policy with respect to discharge of director liability resolutions, which are commonly found on annual meeting agendas in Europe. In the past, RMG recommended that shareholders vote for the discharge of liability of directors and management unless there were serious questions about the actions of the board or management that year or legal action was being taken against the board by other shareholders. The new policy position is that RMG will recommend that shareholders vote for discharge unless there is "reliable information about significant and compelling controversies that the board is not fulfilling its fiduciary duties" as evidenced by lack of oversight, conflicts of interest, potentially illegal actions by the board, or other "egregious" governance issues leading to legal action by shareholders against the company or directors. RMG's stated intention is to use the discharge vote as a way to issue a warning to directors without voting for their removal from the board.[6]

Independent Board Chair Shareholder Proposals

RMG continues to recommend in favor of shareholder proposals requiring an independent chair of the board of directors unless the subject company maintains a "counterbalancing governance structure," including a designated lead director. However, RMG is eliminating a requirement that companies disclose a comparison of the duties of lead director and chair and a rationale for combining the roles of chair and CEO. RMG is continuing to impose the criterion that a company not have exhibited poor shareholder return (using the same "methodology" described above) unless there has been a change in the chair/CEO position during the preceding three years.[7] This policy typifies RMG's "one-size-fits-all" approach to assessing what governance structure is most effective for a given company. RMG does acknowledge in its policy update that academic research has

---

[5] RMG 2009 U.S. Updates at 5-7.

[6] RMG 2009 International Updates at 5.

[7] RMG 2009 U.S. Updates at 10-13.

not shown a positive correlation between total shareholder return and the presence of an independent chair.[8]

In one small nod to the importance of directorial discretion, RMG has added a policy position on shareholder proposals to establish a new standing board committee. RMG will generally recommend against such proposals on the ground that they are "overly prescriptive" in that they seek a specific structure that could limit a company's ability to determine the appropriate oversight mechanism for its particular circumstances. RMG has adopted this position in response to the introduction, during the 2008 proxy season, of shareholder proposals filed by labor unions seeking compliance committees to monitor homebuilders' mortgage lending practices. RMG is correct in its view that such proposals represent an attempt by activist shareholders to micromanage aspects of governance that are properly left to the judgment of boards of directors with the advice of management and that "the establishment of such board committees may create additional costs without assuring enhanced oversight.[9]

Shareholder Rights Plans

RMG has revised its policy with respect to management proposals to ratify a shareholder rights plan. In addition to considering whether a shareholder rights plan includes RMG's prescribed attributes (such as a 20 percent or higher triggering threshold and a shareholder redemption feature), which already have the effect of substantially reducing the effectiveness of a rights plan, RMG also will take into consideration a company's existing governance structure, including board independence, existing takeover defenses and "any problematic governance concerns." In the face of these new, subjective criteria, it remains to be seen in what circumstances RMG would, in fact, recommend in favor of adopting a shareholder rights plan. Importantly, RMG is continuing its policy of recommending "withhold votes" against an entire board of directors, if the board adopts or renews a rights plan without shareholder approval, does not commit to putting the rights plan to a shareholder vote within one year of adoption (or, in the case of a newly public company, does not commit to put the rights plan to a shareholder vote within one year following the IPO), or reneges on a commitment to put the rights plan to a vote and has not yet received a "withhold vote" recommendation for this issue.[10]

---

[8] Executive Summary, RiskMetrics Group 2009 Corporate Governance Policy Updates and Process, Nov. 25, 2008, at 5.

[9] RMG 2009 U.S. Updates at 13.

[10] RMG 2009 U.S. Updates at 14-16.

This policy update could be problematic for corporations as they head into 2009. Hostile or unsolicited takeover attempts rose in 2008, a development that is likely to continue to the extent that financing to complete such transactions becomes available. As share prices fall in the troubled market and hostile takeover offers increase, companies are recognizing that takeover defenses play an important role in their strategic planning. A shareholder rights plan is a powerful tool that boards can and should use to protect the company's ability to maximize value for its shareholders. In fact, 2008 brought a dramatic increase in the number of poison pill adoptions; SharkRepellent.net reports that 76 U.S. public companies adopted their first-ever poison pill last year, as compared to 42 original pill adoptions in 2007.[11] Despite RMG's policy, there is hope that shareholders who, in recent years, followed activist leaders in pressuring companies to eliminate their poison pills or declassify their boards of directors may now begin to focus instead on encouraging companies to protect their long-term interests through sound strategic planning and strong, prudent takeover defenses.

In a declining market, companies with net operating losses (NOLs) may find themselves particularly vulnerable, not only to opportunistic investors but also to an inadvertent "ownership change" under Section 382 of the Internal Revenue Code. An ownership change under Section 382 generally involves a greater-than-50 percent increase in ownership by 5 percent shareholders in any three-year period. Section 382 substantially limits the extent to which NOLs and other "built-in" losses stemming from pre-ownership change declines in value can be used to offset future income. One mechanism that boards of directors may consider to protect these valuable tax assets is a shareholder rights plan designed to prevent a Section 382 ownership change.[12] RMG has indicated its willingness to support NOL rights plans under certain circumstances[13] and has adopted a policy position for 2009 that, on a case-by-case basis, takes into account aspects of NOL rights plans such as the trigger threshold, the value of the NOLs, the term of the NOL rights plan, and other factors such as whether the NOL rights plan contains a sunset provision.[14]

---

[11] 2008 data from Sharkrepellent.net.

[12] These "382 rights plans" generally incorporate a 4.9 percent triggering threshold, which deters new shareholders from accumulating 5 percent or more ownership and deters existing 5 percent shareholders from increasing their stake in a manner that would cause a Section 382 ownership change. Section 382 rights plans have been implemented in recent months by companies with significant tax assets, including USG Corporation, Reinsurance Group of America Inc., and Hovnanian Enterprises Inc. *See* Andrew Brownstein et al., "Protecting Corporations' Tax Assets Through Shareholder Rights Plans," Dec. 11, 2008.

[13] RMG recommended a vote "for" Hovnanian Enterprises Inc.'s NOL rights plan.

[14] RMG 2009 U.S. Updates at 15.

Advance Notice Provisions

RMG has updated its policy with respect to advance notice provisions in a company's organizational documents to clarify that it generally will support provisions intended to ensure full disclosure regarding a proponent's economic and voting position in a company, which is an important change in view of new uses of equity derivatives by activist shareholders.[15] Activist hedge funds have been using derivative positions to obtain large holdings without disclosing their ownership levels or intentions;[16] as a result, some companies are considering broadening the language of their poison pill triggers and advance notice bylaws in order to include all forms of economic and voting interests. Advance notice bylaws should be carefully drafted to, among other things, require a shareholder proponent to disclose fully all ownership interests, including synthetic and temporary ownership techniques.[17] In order for a company to inform other shareholders as to the true nature of a shareholder proposal, and for a board of directors to make a recommendation on such a proposal, the company must have the benefit of full information, and RMG's policy update is a welcome development in this regard. RMG also has revised its policy to prescribe a submittal window of at least 30 days prior to the submission deadline, instead of the 60-day period RMG previously mandated, although RMG states that the submission deadline should be no more than 60 days prior to the shareholder meeting.

Capital Structure

In a relatively positive development in view of current economic conditions, RMG has revised its guidelines with respect to proposals to increase a company's authorized number of shares of common or preferred stock. Formerly, RMG had considered proposed increases on a case-by-case basis, subject to the request exceeding an RMG model by no more than 5 percent. RMG now will permit its cap to be overridden in circumstances RMG deems justifiable. RMG's previous policy was to recommend a vote for proposals to approve increases beyond RMG's cap when a company faces de-listing or a prospective inability to continue to operate as a going concern, however, under the revised policy the risk to shareholders of not approving the increase in the authorized number of shares is only one of several factors RMG will consider; other factors include a board's governance structure and practices.[18] Thus, a

---

[15] RMG 2009 U.S. Updates at 14.

[16] *See, e.g.*, *CSX Corp. v. The Children's Investment Fund (UK) LLP, et al.*, 562 F. Supp. 2d 511 (S.D.N.Y. June 11, 2008); aff'd in part, 2008 WL 4222848 (2d Cir. Sept. 15, 2008).

[17] *See* David A. Katz and Laura A. McIntosh, "Corporate Governance Update: Advance Notice Bylaws: Lessons From Recent Cases," NYLJ, May 22, 2008.

[18] RMG 2009 U.S. Updates at 20-21.

company in serious need of capital potentially could have no practical choice but to assent to RMG's governance prescriptions for RMG to support an infusion.

Accounting Issues

For 2009, RMG will recommend a withhold vote from audit committee members (and, in certain circumstances, an entire board) on a case-by-case basis if poor accounting practices are identified that rise to a level of serious concern, such as fraud, misapplication of GAAP, or material weakness in internal controls, and RMG will examine the severity, breadth, chronological sequence and duration of the applicable practice, as well as the company's remediation efforts in making its decision. Formerly, the identification of poor accounting practices automatically would have triggered an RMG "withhold vote" recommendation.[19]

'Corporate Responsibility'

RMG has updated its voting policies on a broad range of social policy matters, including the use of genetically modified ingredients, pharmaceutical pricing, equality of opportunity, gender identity, concentrated area feeding operations, energy efficiency, linking of executive compensation to social criteria, labor and human rights standards and principles for doing business in Northern Ireland. Notably, RMG now will generally recommend approval of shareholder proposals requesting that a company report on its energy efficiency policies. RMG also has combined its vendor standards and codes of conduct policies into an expansive new labor and human rights standard policy.[20] The expansion of RMG's substantial influence into so many policy areas creates potential for abuse by special interest groups and calls into question RMG's ability to make thoughtful recommendations in the face of individualized situations involving potentially sensitive business matters.

Looking Ahead to 2009

Boards of directors face enormous pressure from activist shareholders and proxy voting organizations such as RMG to delegate greater decision-making to shareholders, which, in turn, would strengthen activists and special interest groups. These groups are likely to be further strengthened, as the demise of the broker voting regime, combined with the emergence of electronic distribution of proxy materials, is likely to result in a substantially smaller number of individual shareholders voting in corporate elections. Particularly in a challenging environment such as we anticipate for

[19] RMG 2009 U.S. Updates at 4-5.

[20] RMG 2009 U.S. Updates at 34-39.

2009, it is important that boards of directors not be intimidated by RMG recommendations or other activist efforts. For the good of all stakeholders, directors must remain vigilant in resisting those measures that would impede the ability of the board to exercise its own business judgment in taking decisions intended to produce long-term success and the enhancement of shareholder value.