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## 2006 ISS U.S. Corporate Governance Policy Updates

On November 18, 2005, Institutional Shareholder Services, Inc. (“ISS”), the proxy services company that establishes voting and corporate governance guidelines followed by many institutional investors, released its 2006 U.S. Corporate Governance Policy Updates (the “Updates”). The Updates establish new policies and revise existing policies in many areas that have been the subject of recent shareholders proposals and corporate governance reforms. Among the policies updated are those regarding Sarbanes-Oxley Act Section 404 internal controls, shareholder proposals for election of directors by majority of votes cast (as opposed to majority of outstanding shares), mandatory board consideration of certain shareholder proposals, and guidance regarding a number of other areas including overcommitted directors, compensation issues, and shareholder rights plans (poison pills).

The 24-page Updates document is divided into the following major categories of policies: Audit, Board, Anti-Takeover, Capitalization Requests, Compensation and Corporate Responsibility. This client alert follows the same structure, and is intended to provide a broad overview of the Updates while highlighting the details in several hot topic areas.

### Audit

ISS has not previously issued policy guidance on voting for or against Audit Committee members based on the internal controls of a company. The Updates maintain a case-by-case review process, but note that ISS may recommend to *withhold* votes from Audit Committee members when there are certain Sarbanes-Oxley Act Section 404 issues, notably “material weaknesses” that rise to a level of serious concern, chronic internal control issues, and an absence of established effective control mechanisms.

### Board

#### Majority Threshold Voting for Director Elections

The issue addressed by ISS is the election of directors by the majority of the votes cast, as opposed to the majority of the shares outstanding. Objections have been raised to relying on votes cast in the context of uncontested elections, given that a lower shareholder participation level will allow the results to be skewed more easily. ISS notes that there have been 60 shareholder proposals regarding majority threshold voting for directors during the last proxy season, 16 of which received a majority of the votes cast.

ISS takes the position that it will recommend voting *for* shareholder proposals that call for election of directors by majority of the votes cast, provided that such proposals apply a plurality standard to contested elections (where there are more candidates than board seats). However, ISS will consider recommending voting *against* such proposals if the company has adopted corporate governance principles that present a “meaningful alternative” to majority voting standards and provide an “adequate response” to new and incumbent nominees who fail to receive the majority of the votes cast, which principles should, at a minimum:

- establish guidelines, to be published annually in the proxy statement, regarding the process to follow for nominees who receive majority *withhold* votes;
- outline a clear and reasonable timetable for decision-making about a nominee’s status;

- require management of the process for determining the nominee’s status by independent directors (excluding the nominee in question);
- outline the range of remedies for receiving a majority of *withhold* votes (including, but not limited to, acceptance of resignation);
- require disclosure of the process and the final decision on the nominee’s status, and the timeframe within which such disclosure will occur.

#### Director Over-Commitment (“Overboarded Directors”)

The ISS considers CEO/directors that serve on more than three public company boards of directors, and other directors that serve on more than six public company boards, to be over-committed (“overboarded”). The Updates supplement the existing policy by clarifying that although ISS will recommend *withhold* votes for overboarded CEOs, the *withhold* votes would not be used to prevent service by the CEO on the board of his or her employer.

#### Company Performance Test

ISS added a heightened analysis process for directors of companies included in the Russell 3000 index that have performed poorly relative to their peers under the Global Industry Classification Standard (GICS). “Poorly performing” is based on a weighted average Total Shareholder Return calculation, giving 50% weight to five-year performance, 30% weight to three-year performance and 20% weight to one-year performance. The heightened analysis applied to the determination regarding whether to recommend a *withhold* vote includes review of:

- performance improvement in the past year;
- changes in management or board composition;
- recent transactions at the company;
- overall governance practices, especially recent changes; and
- financial health of the company.

#### Term Limits

ISS maintained the policy of not applying a narrow rule of thumb on director tenure and mandatory term limits, but advised it would issue “cautionary language” when the average director tenure for the entire board exceeds 15 years.

#### Cumulative Voting

ISS continues its policy of favoring cumulative voting for directors, unless there is a “compelling reason” to recommend against it, including a majority threshold voting standard, a proxy access provision in the company’s governance documents, or a “counterbalancing governance structure coupled with acceptable relative performance” consisting of at least all of the following criteria:

- annually elected board;
- at least two-thirds of the board consists of independent directors;
- nominating committee consisting entirely of independent directors;
- confidential voting, other than in connection with proxy contests;
- shareholders have the right to call special meetings or act by written consent with 90 days notice;
- all classes of voting stock have equal voting rights (no class has superior voting rights);

- board has no right to change its size beyond a shareholder-approved range;
- company has performed at least as well as its peers and its index on one-year and three-year bases (unless there has been a change in CEO in the past three years); and
- no director received 35% or more *withhold* votes in the last election.

### Obligation to Act on Shareholder Proposals

ISS has held a policy of recommending *withhold* votes from all nominees that have been on boards that have ignored shareholder proposals either approved by a majority of votes cast for two consecutive years, or approved by majority of shares outstanding in last annual or special meeting. The Updates clarify that this policy applies also to shareholder proposals regarding which management has made a contrary recommendation (regardless of whether *against*, *none*, or *abstain*), and adds that any such recommendation will be considered a shareholder proposal for purposes of the test.

### Shareholder Rights Plans

ISS will maintain its policy of opposing shareholder rights plans that limit the ability of a future board to redeem the pill (dead-hand, slow-hand and similar arrangements) by recommending *withhold* votes from director nominees for companies that have adopted such poison pills or any poison pill that was not adopted with shareholder approval (unless there is a requirement, or commitment of the board, to receive shareholder approval within twelve months of adoption). The Updates also note that ISS will recommend a *withhold* vote from any company for which director nominees have not already received a *withhold* vote recommendation of ISS, if such companies adopted a poison pill plan after January, 2005, without either shareholder approval or the commitment to seek shareholder approval within twelve months of its adoption.

### Anti-Takeover

Providing further guidance on its policies regarding Shareholder Rights Plans, ISS notes that it will evaluate poison pills on a case-by-case basis, but that they should not have any of the following terms:

- lower than 20% trigger, flip-in or flip-over;
- more than three-year term; or
- limitation on the ability of a future board to redeem the poison pill.

Such poison pills also should include a shareholder redemption feature, such that if the board refuses to redeem the poison pill within 90 days after a qualifying offer is announced, holders of 10% of the shares may call a special meeting or seek a consent to vote on rescinding the poison pill.

The Updates also clarify the ISS policy to recommend a vote *for* shareholder proposals requiring that poison pills be submitted to a shareholder vote or be redeemed, unless the company already has a shareholder-approved poison pill in place, or the company has a policy specifying that the board will only adopt a poison pill if the shareholders have approved it (or, if expediency requires a board-only adoption, the pill is subject to shareholder ratification within twelve months following adoption by the board).

## Capitalization

The Updates address two capitalization-related issues, each of which it will review on a case-by-case basis in accordance with the following general guidance:

- increases in authorized common stock, which ISS supports if in connection with a transaction for which ISS is recommending approval, and the company meets certain other conditions at such time (including good performance of the company relative to its peers); and
- “going dark” transactions (intended to reduce the number of shareholders below 300), in connection with which ISS will look to the following factors:
  - whether the company has attained benefits from being publicly-traded;
  - the cash-out value;
  - balancing the interests of the continuing shareholders v. the cashed-out shareholders; and
  - market reaction to the public announcement of the transaction.

## Compensation

### “Poor Compensation Practices”

The Updates change the current ISS practice to a formal ISS policy to recommend *withhold* votes from members of the compensation committee of companies with poor compensation practices. “Poor compensation practices” include excessive severance packages, excessive perks, high bonuses without performance linkage, performance metrics that can be changed during the performance period, and similar practices.

### CEO Compensation Disclosure Requirements

Although not adopting a formal policy in the Updates, ISS strongly encourages companies to provide more transparent disclosure of CEO compensation in the 2006 proxy season, and will consider recommending *withhold* votes from compensation committee members, and votes *against* equity plans, if disclosure is not made more transparent. The Updates detail a CEO compensation “tally sheet” that ISS recommends as a form for such increased transparency.

### Additional Compensation Guidance

ISS provided additional guidance concerning compensation, including equity plans, in the following specific areas:

- evaluation of equity plan proposals in light of a company’s relative burn rate (compared to the standard burn rate for its GICS group);
- adjustment of ISS’s formula for determining total cost of a company’s equity plans (changed to rely entirely on Shareholder Value Transfer, without giving any weight to Voting Power Dilution);
- the effect of Dividend Equivalent Rights on the calculation of award values; and
- the treatment of Transferable Stock Options.

## Corporate Responsibility

ISS adopted new policies on evaluation of shareholder proposals in the following areas:

- company preparations to comply with Kyoto Protocol compliance;



- disclosure of company policies on land use or development;
- reporting on risks relating to nuclear safety;
- reporting on risks and liabilities relating to Concentrated Animal Feeding Operations;
- enhanced reporting relating to ecologically sensitive areas;
- disclosure of policies related to toxic chemicals; and
- reporting on financial and legal impacts of policies regarding prescription drug reimportation.

ISS modified its existing policies on evaluation of shareholder proposals in the following areas:

- requirements to publish the company's political contributions (ISS generally opposes such proposals, but will consider them on a case-by-case basis in light of public policy and any recent controversies or litigation against the company relating to political contributions);
- phasing out of the use of animals in product testing (ISS generally opposes such proposals, unless the testing is unnecessary, suitable alternatives are accepted and used by peers, or there is a recent, significant controversy relating to the company's use of such testing); and
- implementation of specific price restraints on pharmaceutical products (ISS generally opposes such proposals, unless the company fails to adhere to regulatory guidelines or industry norms, but ISS may consider favoring evaluation of product pricing under certain circumstances).

A full copy of the ISS 2006 U.S. Corporate Governance Policy Updates is available on the ISS website ([www.issproxy.com](http://www.issproxy.com)).

For further details on the ISS 2006 U.S. Corporate Governance Policy Updates, feel free to contact any of the attorneys listed below.

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