



ISS and the Removal of CEOs: A Call for an Enhanced Standard

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Recently, shareholder activists have been pursuing proxy contests seeking to prevent re-election of the CEO as a director, by proposing an alternative director nominee. When voting in proxy contests, many shareholders give significance to (or automatically follow) the recommendations of Institutional Shareholder Services Inc. (ISS). The analytical framework that ISS uses to determine whether it will recommend that shareholders support a dissident in a proxy contest depends on whether the dissident is seeking a minority or a majority position on the board, with the standard for a dissident seeking minority representation being significantly easier to meet than if control is sought. However, this framework does not expressly account for whether a CEO is being targeted in a dissident's minority slate.

Replacing the CEO as a company director can harm the company and shareholders. Typically, the CEO is the prime mover in developing and overseeing execution of the company's strategic plan as well as a myriad of other important corporate strategies, actions and relationships. This central leadership function is reinforced by the CEO's status as a director. Moreover, board membership enhances quality, two-way communication between the CEO and other directors. In short, the CEO-director is not "just another director"—and targeting the CEO for replacement on the board, which may well disrupt these key functions, implicates important additional considerations, ultimately bearing on shareholder value. For this reason, ISS should adopt an enhanced intermediate analytical framework in its review process that takes into account whether a dissident is targeting a CEO for replacement on the board.

Growing Trend of Targeting CEOs

According to FactSet, by May 1, 2017, there were nine activist campaigns this year targeting company CEOs for replacement on the board. Though such activity has been steadily increasing since 2011, the number of company CEOs targeted by May 1 of a given year has reached an all-time high.¹ This year, activists have successfully campaigned to replace CEOs on the boards of several major companies, including CSX Corp. and Pandora Media Inc.² In addition, on June 2,

¹ David Benoit, "Activist Investors Have a New Bloodlust: CEOs," *The Wall Street Journal* (May 16, 2017, 8:00 AM), <https://www.wsj.com/articles/activist-investors-have-a-new-bloodlust-ceos-1494936001>.

² Ronald Orol, "Activists Forced CEOs to Leave These Huge Companies This Year," *The Street* (July 8, 2017 8:48 AM), <https://www.thestreet.com/slideshow/14215254/1/activists-forced-ceos-to-leave-these-huge-companies-this-year.html>.

2017, Buffalo Wild Wings' CEO, Sally Smith (who was not targeted for replacement as a director), announced that she would step down at the end of 2017 following activist pressure.³ Crucial to the success of an activist campaign is the support of ISS, whose influence is well documented. As an example, in the Buffalo Wild Wings campaign, following ISS' announcement of its recommendation in support of two dissident director nominees, the company's stock reacted with a more than 7 percent increase.⁴ ISS recommendations are consistent with the ultimate outcome of a proxy contest a majority of the time.⁵ As activist investors become more aggressive with their efforts to replace CEOs, it is incumbent on ISS to be more discerning in its voting recommendations in connection with these types of campaigns.

Current ISS Analytic Framework

There is precedent for ISS to use different analytical frameworks depending on the particular circumstances surrounding the proxy contest. The current analytical framework that ISS uses in proxy contests is twofold. First, ISS considers whether dissidents have made a compelling case that change is warranted at the company and, in particular, at the board level. The factors considered include the company's financial performance metrics (both absolute and relative to peers), management's history of executing its strategic plan, and total shareholder returns at different points on both an absolute basis and relative to a peer group. If ISS finds that the dissident has proven that change is warranted at the board, it will then ask whether the dissident nominees are more likely to effect that change than the incumbent directors. This inquiry considers factors such as the dissident nominees' skill level in the areas that need improvement.

ISS also considers whether the dissident is seeking minority or majority representation on the board. The standard for gaining support from ISS when seeking majority representation is more stringent than when seeking a minority of board seats. When minority representation is sought, ISS does not require that the dissidents put forth a detailed plan of action, nor are the dissidents required to prove that their plan is preferable to the company's plan. Rather, ISS requires that dissidents prove that change is preferable to the *status quo* and that their nominees are more likely to deliver that change than the targeted incumbent board members. However, when seeking control of the board, ISS requires the dissident to provide a well-reasoned and detailed business plan (including the dissidents' strategic initiatives), a transition plan that describes how the change in control of the company will be effected where management continuity may be an issue and the identification of a qualified and credible new management team.

Proposed Changes to ISS Analytic Framework

The identity and qualifications of the CEO are often critical factors in a company's success, and his/her selection by the board is one of the board's most important tasks and responsibilities. While shareholders should have the right to vote to replace a CEO/director on a board who is not performing at an acceptable level, the ISS standard for removing a CEO from the board should

³ Kate Taylor, "Buffalo Wild Wings' CEO is leaving the struggling chain after an activist investor triumphed in a monthslong battle for the board," Business Insider (June 2, 2017 2:25 PM), <http://www.businessinsider.com/buffalo-wild-wings-ceo-out-after-losing-battle-for-board-2017-6>.

⁴ Reuters, "ISS recommends activists nominees for Buffalo Wild Wings board," NASDAQ (May 24, 2017 12:16 PM).

⁵ Glen T. Schleyer, Stephen M. Guynn, Corey R. Inglin, Tengpeng Peng and Chenjing She, "Sullivan & Cromwell Reviews and Analyzes 2016 U.S. Shareholder Activism," Columbia Law School: CLS Blue Sky Blog (Dec. 15, 2016), <http://clsbluesky.law.columbia.edu/2016/12/15/sullivan-cromwell-reviews-and-analyzes-2016-u-s-shareholder-activism/>.

be higher than the “what’s the harm” approach that it applies in its analytical framework for minority representation. Under the current ISS framework, dissidents who target the CEOs of companies while seeking a minority position on the board may gain support from ISS without ever presenting a coherent strategic plan for the company’s future business or specifically stating why the CEO should not be a member of the board. Given its influence on the director election process, ISS should amend its current analytical framework for proxy contests in which the dissident targets the company’s CEO for replacement as a director. In such situations, ISS should require a dissident to provide, at minimum, the framework for any new strategic plan or proposed course of action (including any strategic initiatives being proposed) to ensure that the board and shareholders will have a reasonable understanding of the dissident’s thinking before shareholders act to replace the CEO on the board. Additionally, regardless of whether the dissident has identified a new CEO, the dissident should be required by ISS to set forth clearly the vision and initiatives that the current or new CEO will be urged to follow and the specific rationale for the change from the status quo.

I do not believe that the level of scrutiny applied to a dissident that targets a company’s CEO in a “short slate” fight should be raised to fully match the level of scrutiny applied to a control fight. However, ISS should require the dissident to present the framework for moving forward with a new CEO. Put differently, if a dissident seeking control of the board is required to present ISS with a “fully baked” plan, a dissident seeking a minority position along with removal of the CEO should put forth a written recipe with most of the ingredients that lay out a plan that is almost ready to be put in the oven. To require anything less would be a disservice to shareholders by allowing minority proxy fights that target replacement on the board of the company’s CEO—which, if successful, can have a major disruptive effect on the company’s leadership, internally and externally—to be influenced by the lower ISS standard that completely ignores this disruption risk.