Meeting Activist Wrath with Reputation Resilience

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The right to bypass a board of directors and directly nominate directors is a strategic weapon activists have long been seeking. Proxy access, which has been approved by shareholders in 48 of the 69 times it has been discussed at corporate annual meetings this year, renders useless tactical defenses like Directors & Officers liability insurance, for instance. Indemnification means nothing when activists are holding Directors personally, repeat personally, culpable for a range of adverse events such as food safety failures, corruption and environmental accidents. Companies where investors have voted in favor include McDonald's, Duke Energy, and most recently Chevron.

Like strategic nuclear weapons, proxy access works because being threatened with removal from a board is a clear, credible and very personal message that directors can easily understand and fear. "Proxy access has more power when it is not used," said Andrew Logan of Ceres, the investor network that campaigns on environmental and social issues. Zach Oleksiuk, head of the corporate governance team for BlackRock America recently explained that the existence of the shareholder right to nominate directors "should obviate the need for its use."

The purpose of the weapon, according to activist investors representing the large public employee retirement funds in New York and California, is to "make directors more accountable and contribute to increased shareholder value." Tactical maneuvers by increasingly out-gunned boards will not defeat these strategic weapons. Chevron's warning that proxy access would enable small groups of shareholders to "nominate directors to advance their own agenda" failed to sway a majority.

Directors have two credible strategic options to preempt the weapon's deployment. The first is to undercut the premise that a nuclear option is needed to get the board to focus on "increased shareholder value."

Boards have been signaling that they get the message. Share buy backs and dividends are strategic signals that inform shareholders that there is still upside in fair market value, and that ample cash can be spun off from operations. These are clear and credible signals that shareholders can easily understand and appreciate. Said another way, money talks.

Cash returned to shareholders in the US was over $900bn in 2014, with $350bn paid out in dividends and $553bn in own share buybacks according to S&P Dow Jones Indices. Since 2009, according to Lu Wang and Oliver Renick at Bloomberg News, "companies in the S&P 500 have spent more than $2 trillion on their own stock." In a March 2015 report, they noted that stock buybacks and dividends are eating up "almost all the Standard & Poor's 500's earnings."

When higher interest rates make these tactics economically irresponsible, Directors have a more strategic and much more responsible option: to undercut the premise that a nuclear weapon is needed to "make directors more accountable" – the governance, risk and compliance option, or what we prefer to call the reputational resilience option.

In this respect, boards have been less effective in their signaling. Governance, risk management, and compliance disclosure in regulatory filings, social responsibility reports, and ethics and compliance reports are all signals that boards get the message. But this messaging has not had the same gravitas or impact nor is it as robust and convincing as talking money.

That's why in the context of reputationally damaging events such as supplier-related food safety issues, environmentally-damaging waste spills, a corruption scandal or a cyber-security event, where exculpatory signaling is most needed, crisis communications efforts are merely whispers in the face of a roar of opprobrium.

While it takes time and thoughtfulness to establish, reputational resilience is an option that once built and tested, will provide investors and other stakeholders' comfort and value. A company (and its CEO, C-Suite and board) that responds to demands for accountability by building and deploying organizational reputational resilience is building long-term value. It is also creating the corporate muscle and brainpower needed to deal with the vicissitudes and crises that will inevitably come. And, in the meantime, behavioral economics notwithstanding, even the Code of Federal Regulations concedes that such actions earn a firm the right to receive "exculpatory credit".

It is hard to fathom why a business – its CEO and board – would not prefer to lead a company with internal resilience when a food safety scare happens in China? Wouldn't a Director prefer to lead a company with a powerful cyber-security defense program (providing such exculpatory credit, through organizational resilience) in the face of a massive cyber-hack-attack? Are not millions, even billions, in fines for violations of the Foreign Corrupt Practices Act sufficient motivation for an Audit Committee to insist on having reputation resilience to mitigate regulatory wrath?

For boards whose companies have already developed superior governance, risk and compliance programs and processes, now would be the time to let shareholders appreciate and value them with clear and credible signals like board performance bonds. And for companies that are still on the journey, act now while interest rates are still low.

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