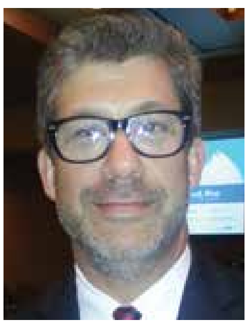
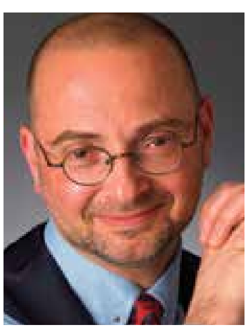
Why Having the Backs of Good Directors Is Better Than Clawbacks

By Paul Liebman and Nir Kossovsky





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Board compensation committee members would be justified were they to demand extra pay for hazard duty: they can expect to face as many as 700 activist investor campaigns. According to the National Association of Corporate Directors (NACD) blog post "Executive Compensation—What Matters Most to Activists?" executive compensation is the hook for marshaling support in each campaign. And, according to *Fortune*, the mobilization strategy appears to be working: institutional investors, "once-quiet and conflict-averse," are buying activists' arguments.

Clawbacks are the top reason compensation committee directors feel they are in the crosshairs. During a panel discussion on compensation committee disclosures at the 2015 NACD Global Board Leaders' Summit, more time was spent discussing the implications of clawbacks than on the other significant parts of the say-on-pay provisions of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.

Securities and Exchange Commission (SEC) Chair Mary Jo White bluntly explained the regulator's stance in July 2015: "Executive officers should not be permitted to retain incentive-based compensation that they should not have received in the first instance." In the Sarbanes-Oxley Act of 2002, the clawback provision relates to enforcement actions against CEOs and CFOs for bonus compensation stemming from financial restatements made because of wrongdoing. Dodd-Frank, however, expands this provision to enable enforcement action even when CEOs and CFOs were completely unaware of any wrongdoing done by others.

These highly prescriptive rules imply that companies lack responsible directors. No wonder the panel discussion was spirited.

The directors in attendance did not dispute that it makes sense for there to be repercussions for an executive under whose watch enterprise value was destroyed. However, they agreed that tailoring clawbacks to accounting issues is not the best form of governance. They also generally agreed that the rules would undercut a board's authority and weaken governance. In addition, they feared that such an approach would expose individual directors to unwarranted pain.

Activists often leverage media attention to garner support from the public at large when they mount an attack against a company. A director's reputation becomes collateral damage. Costs to a director's personal reputation include public humiliation and lost professional opportunities.

Reputation protection solutions emerged in the past few years for directors and officers to mitigate activist-induced pain. Reputation Assurance Side "R" from Steel City Re, for example, indemnifies clients for funds advanced to directors to counter personal adverse media, mitigate personal potential going-forward reputational value loss, and indemnify for personal opportunity costs. It is worth considering whether these reputation-based solutions might point toward a better clawback strategy.

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The personal director and officer reputation solutions deliver warranty-like benefits to both the insured and to his or her leadership team, as described in an October edition of *Agenda*, the *Financial Times*' newsletter for corporate directors. These solutions are available only to companies meeting specific index-driven criteria evidencing above-average reputation controls as a prerequisite for acceptance by the insurer. As described by NYSE Governance Services' blog, a reputation risk indemnification structured like a performance bond or warranty with indexed triggers communicates that directors had taken appropriate preventive measures. That signal will lead the jurors in the court of stakeholder opinion to largely exonerate the company and its leadership.

Consistent with the SEC's objectives, the clawback solution would turn the tables on the insured and the insurer. An executive's bonus would capitalize a captive insurance instrument. If an adverse event occurred and the company's reputation was impaired by wrongdoing—whether or not the CEO or CFO was aware—the captive insurance would drain the executive's bonus to indemnify the company. Such a solution would be objective and transparent, and, if enacted, would meet both the original alignment intent of Sarbanes-Oxley and the disclosure intent of Dodd Frank. It would also preserve the board's authority as the originator of the solution and determinant of the trigger thresholds and costs.

One of the overarching benefits of this strategy is that it addresses another persistent board issue: reputation risk. According to a 2013 Ace European Risk Briefing, reputation risk is the sum of going-forward losses from "damage to customer relationships, loss of earnings, and fall in the share price." A diminished ability to form new customer relationships, tainted brand perceptions, and loss of key staff or the ability to recruit employees were listed among the top eight sources of going-forward loss. The impact of these factors together can be catastrophic to the corporation, its executives, and board members.

U.S. Deputy Attorney General Sally Yates issued a memo in September informing companies that in order to receive a reduction in penalties for cooperating with regulators, they would need to "identify all individuals involved in, or responsible for, the misconduct at issue, regardless of their position, status, or seniority." That is why managing compliance risk and reducing going-forward losses has been demonstrably successful through preemptively deploying preventive processes and communicating an honest, documented intent to comply. Doing so, and providing third-party attestations in the form of reputation insurances, assures regulators that any non-compliance was beyond management control and that, when accompanied by appropriate and timely mitigation efforts, management and the board should be held blameless.

These reputation-based indemnification instruments, structured like a performance bond or warranty with indexed triggers, communicate the quality of governance, essentially absolving board members of damaging insinuations by activists. Using these same principles in a solution to link management bonuses directly to enterprise reputation value, and to reduce the value of those bonuses when reputation value is damaged, will doubtless get a fair hearing as the basis for a reasonable alternative solution to the clawback challenge.

One basic reputation-linked solution can do so much: protect directors personally, affirm the integrity of a board, preserve the board's governance authority, and create pain for an executive under whose watch enterprise value was destroyed. In the court of stakeholder opinion, this strategy is a winner. D