SPECIAL SECTION

The role of the board in times of economic uncertainty

CONTENTS

The role of the board in times of economic uncertainty in the US | 59
The role of the board in times of economic uncertainty in Europe | 61

The role of the board in times of economic uncertainty in the US

BY PAULINE RENAUD

With scores of US companies collapsing or posting record losses in recent times, boardrooms are often blamed by regulators, creditors, the media and particularly stakeholders for making the bad decisions that led to the company's distress. When under such pressure, it is essential that boardrooms show solidarity, responsibility and strong decision-making skills in order to navigate the downturn and regain the confidence of shareholders and regulators. This involves high standards of communication and transparency. Indeed, businesses with an established corporate governance culture tend to be stronger, and therefore more attractive to investors and their much-needed capital. But with greater government and shareholder scrutiny in the current downturn, there are fears that boardrooms are becoming increasingly disempowered.

Board responsibilities amid the crisis

The roots of the financial crisis have been continuously investigated over the last few months and most commentators agree that the effects are due to a combination of factors. Poor decisions made by board members are most certainly among them, and it is only right that they should be held partly accountable if their companies are experiencing financial difficulties. "Boards of some of the large financial institutions should absolutely accept responsibility for not knowing what was on their balance sheets – or maybe more accurately what value was not on their balance sheets," says Deborah Hicks Midanek, president of Solon Group. "That said, the problem is based on a system in which all were doing their jobs, but there was too much money chasing too few assets, and too much distance between the guy who originated the asset and the guy who had to collect it." A function of that system was that boards, or certain members of them, were often too deferential to management, and were consequently unable to limit the company's exposure to risk. As such, many of them have been reproached for their lack of involvement, in light of the fact that they were elected by shareholders to take care of their money.

However, boards today are more balanced than has historically been the case, notes Michael Dockterman, a partner at Wildman, Harrold, Allen & Dixon LLP. "There are more independent directors today and they meet in executive session, formally, rather than in rum groups. So there is more of a challenge to the conventional wisdom of their companies." But the mere presence of independent directors on the boards of US companies is not always a sufficient safeguard against financial risks. "Independence necessarily brings a lack of familiarity with the businesses being overseen, which makes oversight harder," he continues. For example, succession and compensation, two of the most important board functions, are often outsourced to consultants whose suggestions are not properly scrutinised, warns Mr Dockterman. As such, it is important that board members bring their own independent experience to bear in a critical way, rather than merely defer to the consultants, when applying the consultants' specialist knowledge and training to the companies they oversee.

It is perhaps not surprising then that some shareholders currently have a negative perception of their board members. Common complaints focus on the lack of appropriate oversight of management, and that the companies are continuing to pay executives at similar or even higher levels in spite of their failures. Some shareholders have lost a lot of money and are therefore anxious that returns will not be at the levels they had come to expect. However, they are perhaps beyond blaming the board for that. "Shareholders are frightened and confused about the variety of issues that have come to light during the recent credit crisis," says Ms Midanek. "I doubt though that the ire is specifically directed at the boards, which would in many cases be appropriate, because there is little belief remaining that the boards can be effective. I think that management and shareholders alike see boards largely as a nuisance they have to put up with, and not as active stewards adding value through their focused attention."

In general though, the way shareholders regard their board members largely depends upon the industry, and how they have been faring in the ▸▸

crisis. "Some corporate boards saw this debacle coming. The metrics did not make sense, they saw around the corner, they applied sound business judgment, and they extracted or protected themselves from the fall. As to those boards, they are highly regarded," says William N. Howard, a partner at Freeborn & Peters LLP. "On the other hand, many shareholders now see the fallout of the short-sighted decisions, the 'fad' securitisation, the quick-buck scenario. Those shareholders, previously anxious to capitalise on emerging trends and investment strategies, now see the emperor with no clothes." In such cases, shareholders generally hold their boards entirely responsible for the performance of their companies and, as a result, are intensifying their scrutiny of board decisions, membership and philosophy.

This may mean asking for changes. "Shareholders want accountability," asserts Mr Dockterman. "That means accountability of management and, if it is not clear to shareholders that management is being called to task by the board of directors, shareholders will call the board to task. So you will see more votes like the recent Bank of America decision to take Ken Lewis out of the chair. Those changes are merely manifestations in a shareholder resolution of the broader demand that someone must watch the store." In the case of Ken Lewis, shareholders were frustrated by his leadership, specifically an acquisition spree that, in their view, wrecked the company. However, he has remained chief executive after the board unanimously expressed support for him to stay on as a CEO, subject to oversight by a strengthened board.

Ultimately, the board of a struggling company cannot please everyone – in the short term, it is simply too late. They are often stuck between shareholders, whose priority is their investment, and creditors who wish to maximise their recoveries. Therefore, "directors need to understand the contour of their fiduciary duties in the context of financial distress," says Richard De Rose, a managing director at Houlihan Lokey. "In balancing conflicting stockholders and creditor interests, directors remain entitled to the 'business judgment rule' presumption that they are acting independently, in good faith and with due care. The more reasoned and informed the process by which directors decide upon a particular course of action, the more likely that decision will be deemed a proper exercise of business judgment." Indeed, under Delaware law, as long as the decision-making process is proper and undertaken in good faith, the board is permitted to pursue any strategy that it believes will maximise the value of the company.

Taking action

As such, and in light of the current climate, boards have been encouraged to pursue such strategies and to generally take appropriate action, where required. However, this does not mean taking action for action's sake – sometimes, and particularly in the early stages, the opposite is required. "In times such as we face presently, perhaps the most important thing any board can do is to be introspective, take a hard look at what its core values are, what the company's sweet spot is," explains Mr Howard. "This introspective re-trenching is crucial, as better decisions will be made in the short run, to better ensure a long run. Shareholders should embrace this introspective look, as the core values of the company may be what brought the shareholders to the table in the first place." Once this 'back to basics' self-evaluation is completed, companies are then in a better position to take the crucial steps to evaluate the current and potential stresses they face, before addressing them.

Ultimately then, a well-considered crisis plan may turn out to be essential to the company's survival. "Management reviews, self-assessments, risk assessments and strategic planning should be at the top of the list," instructs Mr Dockterman. "Board members are elected to boards because they bring a variety of skills that can help businesses evaluate their strengths and weaknesses, make contacts and think creatively. But board agendas generally are not focused on how boards can help, rather, as a rule, they are presentational or driven by immediate issues." As such, management's crisis plan alone may be insufficient, and boards will need to have at least one member that specialises or has personal experience (either as a board member or an executive) in risk management. Indeed, they have a vital role to play in terms of evaluating the risks associated with corporate strategies, defining the risk appetite of the company and ensuring that appropriate resources are devoted to risk identification, avoidance and mitigation. Some experts go further still, and insist that risk management should not be relegated to a single department or individual.

Management's crisis plan alone may be insufficient, and boards will need to have at least one member that specialises or has personal experience (either as a board member or an executive) in risk management.

It is also argued that the frequency of board meetings should be increased, in order to gain a more accurate insight into the financial situation of the company, as well as enabling quicker reactions to problems that arise before they get out of hand. For example, liquidity issues can be addressed by reviewing the company's near-term business plan, assessing whether the company's cash management system is adequately controlled and developing contingency plans for accessing liquidity and capital beyond traditional sources; with operational issues, an 'early warning system' to carefully monitor the company's performance is recommended, explains Mr De Rose. Boards should also assess their companies' capital expenditures, as well as determining which of them can be deferred, and should evaluate pension liabilities and funding in light of the current decline in plan assets. And with accounting, the impact of any accounting practices on companies' balance sheets and financial statements needs to be understood. Furthermore, the accounts receivable needs to be reviewed in order to adjust the reserves for any bad debts.

As an aside, some experts also recommend that affiliate transactions should be reviewed by a committee of independent directors. They also believe that boards should regularly analyse the likelihood of success of potential alternatives, as well as enquiring as to whether management has viable contingency plans in place. For all these steps, the help of external advisers is often useful, and shareholders have an important role in getting the boards to seek it. "It is not uncommon for management to resist outside assistance without prompting from the board or other stakeholders," agrees Mr De Rose. "Reasons range from denial to management's confidence in its own ability to work through the problem. The board must make an unemotional assessment of manage- ▸▸

ment's ability to deal with issues facing the company and seek appropriate assistance from outside sources. Timely decisions can help build credibility with stakeholders."

In general, the overall process of communication between boards and shareholders may need to be reviewed and, in some cases, improved, recommends Mr De Rose. He advises that boards should at least "monitor the company's public disclosures in light of the company's financial position under current conditions. Recent high-profile lapses, such as Bear Stearns, have significantly raised the bar in terms of the nature, extent and clarity of financial reporting that troubled public companies should provide. Increasingly, distressed companies are disclosing that they are considering a bankruptcy filing," he notes. Hiding the truth is no longer an option – shareholders and creditors alike are often far more amenable to tough decisions if they are kept in the loop.

Learning from history

The current downturn has ultimately meant that boardrooms are facing greater government and shareholder scrutiny than has been usual. Some say that this has been a positive development, and necessary to avoid repeating the mistakes of the past. Others, on the contrary, believe that increased oversight in the future might hinder the power and ability of boards to take action. Mr Howard, for one, believes that the current administration is invading the private sector, which could be potentially devastating. "The boards, which are supposed to make decisions based on the best interests of the corporation and its shareholders, now have a new master to consider, the government. That is neither the intended, nor the healthy way for corporate boards to make decisions. So boards, whose corporations accepted and only survive because of federal bailouts, will have less power in the future, as there will be another set of eyes looking over their shoulder, with yet another set of priorities and interests to consider." He believes that the free market should determine the fate of businesses, not the US government, and is concerned that companies bailed out by the administration must answer to the government before their shareholders. But the extent of government oversight going forward is not set in stone.

Nonetheless, other analysts clearly share this fear, with many feeling that boardrooms may be restricted in terms of what action they can reasonably take in the months and years to come. But Ms Midanek insists that boards should continue to fulfil their role regardless of the challenges. "At the end of the day, the corporate board plays an important role in building and sustaining healthy enterprises, in a way that neither shareholders not at the table nor regulators can. In the short run, there may be some noise from shareholders or regulators, but boards of directors must not be allowed to pass the buck. They must accept responsibility for their corporations' health, and do the job they have been engaged to do," she explains. Furthermore, the government as owner is a fairly recent development, so federal and state government regulators may lack the resources and political support to bring enforcement action.

Even the most optimistic market commentators will acknowledge the fear that boards may end up being stuck between the need to satisfy shareholders, and the constraints of enhanced scrutiny. It is, unfortunately, the lot of a distressed company in an economic downturn. But the challenge does not have to be seen in a negative light. For one thing, it has put more emphasis on the need for a strong corporate governance culture throughout the company and its board. Furthermore, while the current crisis may have changed the way boardrooms are viewed by their shareholders, those shareholders are also seeing themselves and the role they have to play in a different light. Their input can be extremely valuable, and as long as communication is consistent and comprehensive, the shareholders and the board will be able to work together to find the best solutions for the company. ■

III The role of the board in times of economic uncertainty in Europe

BY CLAIRE SPENCER

Shareholder activism is on the rise, and the boards of many European companies are feeling the pressure. Accused of making poor strategic decisions in times of plenty and a general lack of foresight, directors are having to come to terms with the fact that the power to run their companies may, to some extent, be subject to dilution. This is not necessarily a bad thing, but it is important that shareholders do not apportion blame unfairly, and more important still that it is not a primary focus when making the necessary changes to ensure a company's ongoing survival.

The blame game

It has traditionally been held that the boards of European companies, particularly those from European Union (EU) member states, are less susceptible to shareholder activism due to their ownership structure. This is now changing – ownership structures are shifting, institutional investors are getting organised, and shareholder activism is on the rise as a result. But it may be early days yet. Nick Hood, the executive chairman of Begbies Global Network, notes that the split between activist and apathetic investors is currently fairly even, but stresses that "the former are the issue for board members because they are well-informed and articulate, especially in the media in high profile cases. Furthermore, all board members are in the firing line: executives for their disastrous strategic decisions and supervisory members for their failure to control the executives. Any sympathy about problems beyond management boards' control because of global factors is limited by the prevailing mood of revenge about executive greed," he says. The environment for directors will be challenging, but it is thought that most will weather the storm.

On the other hand, there is some recognition that the board cannot be held entirely culpable. In times of plenty, many shareholders actively encouraged boards to tolerate increased levels of risk if the returns looked good. As such, in certain regions and scenarios, shareholders accept the fact of reasonable losses. This is particularly notable among companies based in Sweden, says Svante Johansson, a partner at Linklaters LLP. "There is a widespread acceptance among shareholders that board members in general can not be blamed for the economic downturn. Board members in Swedish companies are, with a few exceptions, granted discharge and re-elected to an extent that is not different from good times. There have, of course, been some exceptions where there has been discussion, primarily on greed, bonuses or other profit sharing arrangements." He adds that he recently saw shareholders at an annual general meeting actually criticise the fact that the managing director received no bonus for the 2008 financial year.

Of course, activism of that sort is quite rare across Europe, and boards will have to accept that much of what they do will be subject to potentially adverse scrutiny and challenges while the economic downturns prevails, and possibly beyond. This is hardly undeserved in some cases, and individuals who made ill-conceived decisions may be forced to ▸▸

The looming threat of increased oversight will often insinuate itself into the decision-making process, so board members need to be aware of when its influence is doing more harm than help.

admit their role. "Every party has to end sometime and many management boards failed to hear the music stop," asserts Mr Hood. "Retail is a prime example, where an entire sector is being devastated by overcapacity, much of it created when any sane businessman would have been scaling back investment and closing marginal stores, not opening new temples to rampant and unsustainable consumer spending." But the majority of boards may feel that they have had no choice but to respond to the crises as they arose, and were perhaps only indirectly responsible for the hurdles their companies have subsequently faced. "Regulators around the world were not able to anticipate the financial crisis, so it is probably disingenuous to expect board members to have foreseen the current problems," says Michal Berkner, a partner at Skadden, Arps, Slate, Meagher & Flom (UK) LLP. "That said, boards should understand that shareholders do expect them to accept responsibility and have robust risk management practices that might have at least prepared them for the eventuality," she adds.

Taking action amid change

So it may well be the case that some boards are less at fault than others, but realistically, their saying so will not wash with the shareholders of today if the company is in serious trouble. As such, dispensing blame is far less important than how the board of directors acts after the fact. At the very least, they should be trying to reduce costs, maintaining and enhancing their relationships with investors and bankers, and taking the right opportunities where possible. Non-core assets should be sold if the company has cashflow issues, even if the valuations may be lower than expected. Enhancement of the company's risk management framework and policies is also recommended, as well as an increased focus on stress-testing assumptions.

Ultimately, it all comes down to change. The economic climate has changed, so it follows that the board of directors must move with that change in order to keep the company flexible and solvent. Ms Berkner suggests that boards are increasingly getting involved in activities that were formerly the remit of management. "This trend will continue, which may result in independent directors holding fewer directorships in order to provide the requisite focus and proximity to the business." Furthermore, she identifies transparency as a key change going forward. "Boards should be taking the initiative to increase transparency with respect to the operations of the board, the competencies of members and, in particular, compensation levels of both board members and senior executives," she recommends.

However, not all boards were taken aback by the financial crisis, and as such have not really had to change very much. For example, Mr Johansson explains that the members of a Swedish board have always had a strong incentive to closely monitor their company's financial position. "We have a rule that, in short, states that if the net value of a company's assets drops below 50 percent of the company's share capital, the company should be recapitalised or put into liquidation. In connection with such a capital shortfall, there are a number of formal steps that have to be taken by the board and if the board does not act correctly, the members of the board faces the risk of being personally liable for the company's debts, which has occurred after the fault by the board." But he maintains it should always be about more than personal interest – board members should always act in the best interests of the company, regardless of the economic climate. There is often a temptation to feel as though they owe something to parties such as suppliers, employees and the state, but the company and the shareholders should always be the priority.

Of course, the looming threat of increased oversight will often insinuate itself into the decision-making process, so board members need to be aware of when its influence is doing more harm than help. "Many executives fear not just scrutiny, but actual interference by governments and lenders," says Mr Hood. "This is not the real issue. The problem is not overt control being exercised, but the deadening effect on entrepreneurialism of the fear of that it might. Board members will certainly be subject to more scrutiny and will feel less powerful, which is not a bad thing, but they must remember to avoid spend their time looking over their shoulders for potential critics." Clearly, there is a balance to be struck between ignorance and missing the forest for the trees, and boards will need to become proficient at sifting through the inputs that come their way.

With this in mind, it should be abundantly clear that the most important input will come from shareholders, and it is likely that their power (and perceived power) will increase going forward. But this is only allowing them to become what they ought to be anyway, says Mr Johansson. "In the Nordic countries, the general meeting of shareholders is, according to law, all mighty when it comes to making decisions on matters relating to the company. In other words, the general meeting may always pass resolutions, which resolutions will be binding for the board, on any matters regarding the company. Therefore, the distribution of power between the shareholders and other company organs, such as the board, is not a legal question but a question of tradition, the personality of the persons involved and other less tangible factors," he says.

Finding the source of a company's woes is desirable, but it is only part of a much larger process. Tackling the symptoms, which many boards have been doing out of necessity, is also part of it, but shareholders can really galvanise the most important element – namely, changing the company's approach to transparency and corporate governance so that its framework and business plan is more flexible in the future. And this is already happening, with shareholders making use of their powers by exercising their right to decide matters that were traditionally the remit of the board of directors. It is unknown as to whether this will continue, but provided that both the board and the shareholders have the company's interests at heart, it can generally be seen as a positive thing. ■