

The role of the board in preventing corporate freefall

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If fall is the season of cooling temperatures, then the autumn of 2008 should be remembered as the “deep freeze”. In a three-week period beginning in September 2008, eight renowned financial institutions teetered or fell. And like dominos dropping, they brought the US financial system to its knees and sent the global economy into a tailspin. Lehman Brothers filed for bankruptcy. Fannie Mae and Freddie Mac were seized by the federal government, as was AIG, effectively, in the form of an \$85 billion bailout. Washington Mutual and Merrill Lynch, both on the verge of collapse, were forced to sell themselves hastily to larger rivals.

All of these firms had top-notch talent, many decades of history, and well-respected businesses and brands. All had relatively diversified and accomplished boards, although some would argue they were skewed toward an older generation of executives. They were also publicly traded on the New York Stock Exchange, which requires the boards of its listed companies to assign a committee to regularly review major financial risks and assess steps management has taken to address those risks. The most obvious question that lingers in the aftermath of the deep freeze is: “Where were the boards?”. This question is particularly pertinent in light of the many subsequent revelations of dubious business practices within other financial institutions.

Where were the boards?

A major responsibility of the board of directors is to ensure the viability and sustainability of the firm. When a board’s fiduciary role is largely assumed by US Treasury Department officials, how can the performance of those directors be seen as anything other than inadequate? Some say that these institutions were faced with sudden and unmanageable conditions created by an unfathomably complex and interconnected financial system; they were victims of an inherently flawed system that could be leveled by a few weak links. Many point out that this crisis was unprecedented.

And while this may be true to a degree, this argument overlooks the fact that we were warned about the potential of such a meltdown back in 1998. The collapse of Long-Term Capital Management (LTCM) demonstrated all too clearly that complex financial institutions pose serious systemic risks that require laser-focused oversight by managers and directors.

In the case of LTCM, the directors did not adequately understand the complexity of the firm’s derivative-based trading models and the extent of leverage employed until it was too late. The firm’s collapse forced a massive bailout by other banks and investment houses under supervision of the Federal Reserve.

So what did boards learn from the Long-Term Capital incident? Since 1998, have boards of financial institutions become more engaged in the businesses they are appointed to oversee? The deep freeze of 2008 would challenge a “yes” answer to this question.

Moreover, between 1998 and 2008, we had the monumental failures of Enron, HealthSouth and Worldcom, among others. In March 2004, the CPA

Journal cited ‘passive, non-independent, rubber-stamping boards of directors’ as the most significant transgressor in the governance lapses that led to the scandals in the early part of the decade. The result was the Sarbanes-Oxley legislation, which famously mandated new rules of board independence, management accountability, reporting standards, and other safeguards. Most experts agree that Sarbanes-Oxley did bring about some substantive governance improvements. A December 2008 Business Roundtable survey of member CEOs, for example, revealed that 90 per cent of member company boards were at least 80 per cent independent. Yet, we still had notable failures of corporate governance in 2008, prompting one commentator in *The Wall Street Journal* (October 14, 2008) to ask: ‘Were they lulled into complacency by their CEOs? Or did they lack the insight to see that their firms had placed themselves in great peril if there were major disruptions in financial markets? Or were they looking at computer models rather than applying the judgment they were selected to make?’

There is the key word: what exactly is this thing called judgment? And what kind of judgment will be expected from directors and boards at the close of such a tumultuous decade?

The rubber stamp has left the boardroom

The quaint perception of a director goes something like this: he/she attends four meetings a year, listens carefully to presentations, sits on a committee, and collects the fee. Most directors generally do not second-guess management, at least not openly. On the CEO’s part, he thinks of the board as his advisors, a handful as his confidants, and one or two as his friends. When he is having a tough time with his Asian subsidiary, he might call one of his directors with relevant experience and ask for advice. The following week, he might call a different director just to chat about whatever is on his mind.

Today, there is nothing quaint about directorship. For the past two decades, and most notably since Sarbanes-Oxley, the formality of board roles, discussions, and interactions with management has increased dramatically. More than ever, directorship today requires a substantial commitment of personal time and mental energy. Even retired executives can no longer afford the time and focus to sit on five or six boards, as they might have done in the past.

Today’s directors know their role will be active, business matters before them will be urgent, and

their decision-making may be highly scrutinized. Shareholders pay directors (yes, your fee is their money) to watch over their investment, so a director’s responsibility is to bring an independent perspective to enterprise strategy and risk, and to ensure that management is executing strategy and managing risk suitably. Today, particularly in light of the deep freeze, wise boards govern with the knowledge that the worst can happen.

Unfortunately, this increased sensitivity in boardrooms coincides with a general decline in the operational experience of the average corporate director. In June 2009, *Harvard Business Review* disclosed new research that found only 20 per cent of directors today can be categorized as “experienced CEOs”, a dramatic decrease from 53 per cent in 2000. The Business Roundtable survey mentioned earlier reveals that 36 per cent of actively working CEOs serve only on the board of the company they are managing, and 76 per cent serve on only one additional board. With hands-on management experience harder to find in boardrooms today, it is clear that boards are less equipped to navigate operational declines and other business adversity than in the past.

In a weak economic environment, pressure on directors intensifies due to the possibility of a company entering the ominously named “zone of insolvency”. When a company approaches insolvency, a murky term generally meaning it cannot meet its ordinary debt obligations as they come due, directors’ primary fiduciary duties shift from shareholders to creditors, and the legal protections normally afforded directors under the business judgment rule become less clear. This greatly alters the dynamic of an already urgent situation. It is extremely difficult to maintain the confidence of senior lenders, who tend to be less patient, more demanding, and more likely to request removal of incumbent management and/or appoint a chief restructuring officer. Effective control of the company by its creditors entails a loss of management prerogative and a potential increase in legal liability for boards and directors.

Amid such increased scrutiny, criticism, second-guessing and potential liability, what is a board to do? The key here is vigilance. This quality must become the new reality in boardrooms. Directors need to make sure their eyes and minds are wide open from their first day on the job, and I have two recommendations for doing just that. First, learn the business as if you will have to manage it someday...because you might. Second, assume you are only getting partial information.

Learn the business as if you will have to manage it some day

Generally, boards are most helpful when focusing on the forest through the trees. But it is necessary to study the trees on occasion, too. In the wake of the Enron and Worldcom scandals, 25 per cent of CEOs surveyed by Yale School of Management in 2002 said their board did not appreciate the complexity of the business they oversaw. This is troubling, since in the event of a restructuring, a board needs to take a more active, and knowledgeable, role in challenging the turnaround plans of management.

Reading relevant publications, following trends and asking the right questions are some of the ways directors can keep abreast of the company and its market dynamics. However, vigilance is not just about information; it is also about interaction. Directors should get out and talk to people.

Companies with particularly complex business models or capital structures often come with a steep learning curve for directors. Still, one of the most effective ways for a board to learn the business and the marketplace is by studying the competition. What are your company's relative strengths and weaknesses compared to key competitors? Are competitors positioning their companies or their products differently? Are competitors seen as better equipped to serve changing needs? How many customers are being lost to competitors, and why?

Let us look more closely at this last question. In such a scenario, a common response from management is that a particular competitor is simply "buying the business", or lowering prices in a way that is unsustainable.

However, a wise board understands that any competitor gaining market share is a threat, whatever the reason or rationale. As a director accountable to shareholders, you are obligated to investigate or request management to investigate. For example, you might request a presentation from the relevant managers at the next quarterly meeting. The point here is that directors should not rely solely on management presentations, internal information packets or trade publications to learn about the business.

Assume you are only getting partial information

I often encourage directors to approach their responsibilities and attend meetings and management presentations with an "assumption of selectivity". In other words, directors should assume that management is providing them with information selectively, or withholding certain

intelligence, purposefully or inadvertently. This is not to suggest that senior management are in the habit of dissembling or deception, but that a CEO will use his judgment as to what qualifies as worthy of board discussion. Enron's Ken Lay, for example, decided not to share with his board that whistleblower Sherron Watkins had raised major questions about financial irregularities.

Boards that assume they are getting partial information ask a lot more questions and make a lot more requests. This greater board vigilance may put the CEO on his back foot and affect the level of trust around the room, but the alternative is governance in the dark. Boards have to work at creating a delicate balance, because a CEO who does not believe his board to be in his corner is also problematic. In the September 2002 issue of *Harvard Business Review*, governance expert Jeffrey Sonnenfeld wrote: 'What kind of CEO waits until the night before the board meeting to dump on the directors a phonebook-size report that includes, buried in a thicket of sub-clauses and footnotes, the news that earnings are off for the second consecutive quarter? This is surely not a CEO who trusts his or her board.'

Board vigilance may create tension with management, but it should be seen as healthy tension. It may feel like opposition to management, but it should be seen as loyal opposition. The dynamics of checks and balances should serve to foster a sense of mutual respect. And respect, along with trust and candor, are essential ingredients of healthy corporate governance.

When a company's performance begins to seriously decline, directors must make a point of becoming even more vigilant and engaged. Even if the declines are incremental, the board must respond with urgency. I have seen many boards squander the "luxury" of time by assuming that matters will naturally stabilize or that one weak quarter is no cause for action.

Businesses can unravel at lightning speed; there is absolutely no excuse to "wait and see". Even if the business will not deteriorate quickly, the speed with which the board intervenes can make the difference between what we call a soft landing (restructuring as the culmination of thoughtful strategy) and a freefall (a sudden, unanticipated bankruptcy).

So when there are signs of trouble, how exactly can a board exercise its duties to ensure the best possible outcome? At the first sign of performance weakness, boards should answer the following four questions:

Do we have the right management team for the task at hand?

The CEO is the single most important factor determining the success of a company. That is why the first question boards must answer is whether the current CEO and his team are right for the job, assuming a protracted decline in performance. The CEO's challenge, in most cases, is to demonstrate agility and the decisiveness necessary to lead the company through the difficult times.

Boards should avoid snap judgments here. Some CEOs can make the shift, which helps to preserve continuity in leadership, always helpful when navigating a tough environment. From my experience, however, a majority of CEOs perform better in good times than in bad.

Sometimes a CEO's sales and marketing orientation, which has allowed him to exploit the up cycle, works against him in an adverse environment. According to a survey conducted in 2003 by Seton Hall University, 87 percent of CEOs and financial professionals believe that management's inability to change is one of the three primary reasons that companies fail. "Terminal euphoria" is a common syndrome of incumbent management.

To help in the assessment of management, it is important for boards to understand and keep in mind the nature of performance decline. If the broad marketplace is declining, then the key question is whether the CEO is willing and able to hunker down and retrench. It is this type of assessment that boards of major homebuilders, for example, should have been making in early 2007 when it was clear that the housing market was in steady decline. In a weakening market, companies need to aggressively reduce the overhead cost base that was built up during the growth cycle. The CEO must demonstrate a survivalist temperament. For example, is his highest priority fixed on maintaining liquidity and monitoring cash flow? Can he institute and enforce an aggressive action plan to cut costs and hoard cash? Is he ready to furlough or lay off employees, stretch out vendor payments and/or re-negotiate contracts?

If performance decline is unique to the company, however, then the issue is likely one of core business strategy or execution. Here the mantra is "First, direction; then, traction". Is the CEO's core strategy flawed and is he willing and able to change direction? Is the new strategy demonstrating traction and evident in operating results?

The ousting of Fritz Henderson from General

Motors in December 2009 was a decision based not on his ability to retrench or fix the balance sheet, which by the time of his departure had grown to a record \$42 billion in cash. Instead, Henderson was reportedly removed based on his perceived unwillingness and inability to shift strategic direction, particularly whether or not to sell Vauxhall/Opel, the company's European division, according to many reports. Fair or not, Henderson was unable to lose the "old GM" label. One source was quoted in the *Financial Times* (on December 1, 2009) as saying: 'I don't think anyone thought his tenure was a disaster. This is just a killer board.'

Do we have the right strategic plan?

Most distressed companies face critical challenges beyond the balance sheet. Recapitalization is important for quickly shoring up finances, but it does little to ensure demand for the company's products and services, long-term cash flows, and operational sustainability. While reducing overhead costs is important, particularly during a period of broad market decline, directors and management must acknowledge that you cannot cut your way to a long-term turnaround. Equal focus must be placed on deeper strategic or structural problems in the core business.

In formal strategic planning, typically the board relies on management to perform the SWOT analysis, conduct the market research, present the competitive intelligence, and define the strategic commitments. However, boards should use caution and not rely exclusively on management's "spin" on the market opportunity. Invariably, there will be loyalty to legacy businesses and practices, so boards need to ask detailed questions, challenge assumptions, and perhaps recommend outside consultants and advisors to help guide the planning process.

Directors also need to make sure that management's focus does not wander away from the core business. Think twice if management immediately presents a strategic vision focused on launching new products or entering new markets, on the belief that revenue growth will solve underlying strategic or operational weaknesses. Directors should ensure that the strategic plan is built on a genuine and unassailable competitive advantage. Without a competitive advantage as the foundation of any new strategy, an operational turnaround will be virtually doomed.

As I mentioned earlier, once the direction is agreed, the next step is to assess traction over time. Changing strategic direction is not easy. It may

involve selling off non-core businesses, increasing R&D investments, or retrenching from certain markets. It may involve shuttering factories, reducing headcount, or dissolving brands. Whatever the requisite changes, directors and management must work together to make sure that disruptions are productive, not destructive. The goal is to implement the changes and make traction before conditions worsen and formal restructuring talks are required.

Let us revisit General Motors as an illustration of how difficult it can be to shift strategic direction and escape a flawed business model, particularly in the manufacturing sector. By now, the automaker's legacy costs, labor union dependencies, and lack of organizational agility are legendary. For decades, the company's cost base was deemed to be unsustainable, yet management displayed a bewildering inability to take dramatic action or commit to new strategic directions. GM's market share dropped from 46 per cent of the US automotive market in the 1950s to a 19 per cent share just as it filed bankruptcy in June 2009. As I mentioned earlier, operational turnaround is virtually impossible without an authentic competitive advantage. In June 2009, could anyone have identified GM's unique competitive advantage?

According to recently published research by Harvard Business School, the long and steady decline of General Motors was caused by management's inability to continue doing the three things that had made the company so successful in earlier days: first, pay close attention to what is happening in customers' lives in the context of the larger environment; second, keep an equally close eye on the competition; third, understand how a company's structure and culture relate to its strategy.

Customers. Competition. Culture. These are the three levers that MBA candidates study in Strategic Planning 101. This was not about the need for balance sheet re-engineering. It had everything to do with core business strategy. It is astonishing that a company whose early success was defined by strategic insight could lose that discipline in such a momentous fashion.

A company's genuine competitive advantage must be the ballast that will strengthen the core business over time. A troubled company's end-game, its future condition following a successful turnaround, must be driven by customers and markets, not financial engineering or capital structure. For what features will the market pay a

premium? Which product or quality can the market get nowhere else? Is your brand peerless? Do you dominate your fastest growing markets? The strategic plan must leverage your competitive advantage to produce a unique market opportunity, and that opportunity will generally be the company's only hope for improving performance over time.

Have we protected our access to capital?

Directors do not need to pore over balance sheets, but they do need to direct management to ensure sufficient liquidity to sustain the business in a worst-case scenario. This can take a variety of forms, including new debt, an equity capital raise, or other funding strategies. Troubled companies often attract, and sometimes resort to, unconventional and even predatory sources of capital. Directors should work with management to ensure that all financing options are assessed for their likely impact on a potential long-term restructuring process.

Directors must be familiar with the company's long-term liquidity situation, including debt maturities and covenants. Liquidity is an all-encompassing priority, and so directors must work with management to anticipate possible risks and sensitivities. They must also understand the availability of additional capital sources, such as tapping equity markets or obtaining refinancing from major lenders. It is not uncommon for management's relationships with major lenders to become strained or fatigued during difficult times.

Often, directors are reluctant to engage key shareholders directly, but there is little evidence that such direct exchanges are unproductive. Risk Metrics, the proxy advisory firm, recently studied board-shareholder dialogue at eight of the largest US corporations, where directors generally meet with large investors at least once annually. The firm found that despite a wide variety of formats, the outcome of these interactions, as reported by both sides, was positive. In fact, most shareholders in the study predicted – and welcomed – more frequent exchanges in the wake of the financial crisis of 2008.

Should we hire an outside advisor?

To answer this question, directors must collectively decide to what extent they feel comfortable with the information they are receiving from management and other sources. As a board, are you asking every question a shareholder would ask? Are you comfortable with the quality and thoroughness of the answers to those questions? From my

experience, the answer to both of these questions is often no.

If the board is at all hesitant about the quality of information provided, it should bring in an outside advisor to provide another opinion. Frequently, incumbent management will resist, particularly if they have never experienced a restructuring. They may raise the issue of cost, stating that advisory fees could further weaken the company's financial position. The board should turn such protests on their head, citing the potentially catastrophic costs of acting on incomplete or unreliable information. Investing in a second opinion is a sound investment when the viability of the company is at stake.

An outside advisor brings objectivity, credibility and a wealth of experience in similar situations that can be extremely reassuring throughout the decision-making process. An advisor can also more effectively negotiate with banks and creditors, who will typically become increasingly antagonistic, particularly when dealing with a management team that has already disappointed them repeatedly. A third-party advisor can often help mitigate any negative sentiment and level the playing field for a more thoughtful negotiating process.

There are countless real world examples of scenarios that would have ended up quite differently if it were not for outside advice. I have personally been involved in many of them, including a major North American automotive supplier, where my team and I were brought in to assist in a debt restructuring contemplated by management's business plan. Based on our review of the plan and its assumptions, significant changes were made to the final operational plan presented to the board.

The company seemed to have been in a perpetual restructuring mode. In 2002, its North American business experienced its first annual loss in a decade, resulting in a 4 per cent workforce reduction, a share price drop to a 40-year low, and elimination of its dividend for the first time since the Great Depression. The following year, the company's performance worsened despite a widespread product recall by its top competitor; management had tried raising prices to capitalize on the shortage but this move backfired and their market share slid even further.

From a capital structure perspective, they were caught in a trap. Liquidity had dwindled. It was impossible for them to meet their ordinary debt obligations while also investing in the types of activities required to enable an operational

turnaround. Upon taking over the process, we were able to stop the bleeding by restructuring billions in debt, renegotiating bank loans and covenants, and adding a new line of credit.

From a strategic perspective, we advised the company to explore commodity-hedging strategies, exit certain North American product categories, and shift a variety of support services to an off-shore model, among other actions. The company struggled to cut costs and shift strategy, particularly given its unionized workforce, but ultimately won concessions from its labor unions to shed jobs and close factories. These changes were difficult, even painful, but the company was able to avoid bankruptcy, sustain operations, and generate value for its shareholders over the long term. If they had not sought an outside opinion, they most certainly would have suffered through one of the largest bankruptcies in US history at that time.

Disaster cannot always be avoided, but it can be managed

It is impossible to simplify the responsibilities of directors into four simple questions, especially when discussing an imminent restructuring or bankruptcy scenario. But when a company begins to show distinct signs of weakness, there is no time to learn on the job. By maintaining an aggressive and proactive posture, practicing wide-eyed vigilance every day, and focusing on these four questions at the first sign of trouble, boards will be in the best possible position to avoid the types of freefall collapses we have seen in recent years.

No matter how vital your company appears to be today, adversity or disaster can sometimes strike quickly, and directors and managers may find themselves standing on a precipice in what seems like a brief moment. With billions in shareholder and creditor value hanging in the balance, the last thing stakeholders want to hear from the board is "we didn't know". The truth is that you have been amply forewarned that any company could be out on that ledge in fairly short order. So what are you doing today to prepare for that eventuality?

- *The views expressed here are those of the author and not necessarily of the other professionals at FTI Consulting Inc.*