LEADERSHIP ACUMEN
Issue 18 – August 2004
© Doug Macnamara & Banff Executive Leadership Inc.

BOARDS: BANKRUPTCIES & other BLUNDERS

Most Board members are good people. Many are well educated, relatively wealthy, worldly, important people and make significant ongoing contributions to their communities. All are required by law to act in the best interests of the organization they govern.

Thus, it is one of the biggest disappointments and most difficult of personal times when an organization that you are responsible for finds itself in such terrible circumstances as:

- bankruptcy;
- unexpected large financial loss;
- evaporating member, customer, or citizen support;
- fraud or major regulatory non-compliance;
- failed leadership transition.

The truth is that few of these big blunders come out of nowhere. They have usually been building up for some time with ample warning signals. So how is it that these things happen on the watch of otherwise competent, well-meaning people? Unfortunately, few directors that have been through these experiences will talk about them openly. In some cases, of course, damage control efforts create a conspiracy of silence in order to get the organization back on track as quickly as possible or legal requirements forbid disclosure. Culpability is also rarely assigned amongst the Board members with a senior executive officer (or several) usually "sacrificed" by the organization so as to preserve the credibility of the Board and the organization itself. This successfully deflects attention to the governance issues.

What is routinely missed by Board members themselves, the media and other onlookers is that the legal Duty of Management plus the Duty of Delegation means that no matter how much a CEO or management team might have contributed, ultimate responsibility and accountability for these problems rest with the Board collectively and Board members individually.

Everybody, Somebody, Nobody & Anybody

Whenever there was an important job to be done, Everybody was sure Somebody would do it."

Anybody could have done it, but Nobody did.

When Nobody did it, Everybody got angry because it was Everybody's job.

Everybody thought that Somebody would do it but Nobody realized that Nobody would do it.

So consequently Everybody blamed Somebody when Nobody did what Anybody could have done in the first place!

Does this humorous fable cut close to the reality of your Board's situation?

How many times has your Board delegated action to the CEO, but not asked for accountability reporting in return?

Previous articles in this space have outlined:

- The Real Work of Governance;
- Making Time for Good Governance (and your Duties);
- Stewardship Principles.

Paying attention to these elements can certainly help prevent major organizational traumas and help Board members from being blind-sided. However, let me try to pull out some learning and provide some guidance from having observed/mentored/researched examples of the above blunders.

Bankruptcy

This is one of the worst of all potential experiences for Board members and governors to go through. So ugly a situation and so generally attributable to poor governance it is that an individual who oversees a bankruptcy as a Board member must usually forever declare their involvement in such an episode should they wish to act as a director for any other organization.

- In most jurisdictions in Canada, you are forbidden from sitting as a Director of a registered charity for up to 7 years after being involved in a bankruptcy;
- Stockholders are given special rights to change the Board of Directors during a Chapter 11 Proceeding in the U.S.A;
- Securities Regulators in Ontario, U.S.A., Britain, Singapore, and Tokyo expect Individuals to declare whether they have ever been involved personally or as a Director in bankruptcy prior to being appointed as a Director of a listed corporation. In addition, this declaration must be provided to all shareholders of the corporation and in annual report documents.

> **"*The decision to file for bankruptcy is not one we made lightly. But the management team and Board have determined with our leaders, investors, and advisors that this is the best way to ensure the long-term success of the organization*."**

This is a pretty familiar, almost boilerplate, statement in these cases. So what situations can lead to such an un-resolvable condition for an organization that the "best advisable" course of action is to declare bankruptcy?

Well, of course, any of the following situations that we will address separately: unexpectedly large financial loss; evaporating member/customer/citizen support; fraud, malfeasance or regulatory non-compliance; and failed leadership transition can create desperate conditions. Ultimately though, the decision to declare bankruptcy indicates that in the minds of the Board no "rescue plan" suggested and examined provides them with the confidence that things can be turned around. Most situations of this nature have complex causal elements, and fixing things requires a multi-faceted set of new approaches.
[And what is meant by "long-term success" – after declaring bankruptcy?]

In corporate circles, filing for bankruptcy protection is an option different than actually declaring bankruptcy. This filing seeks to provide the Board and management time to develop a turnaround plan. (See web-link below: "Corporate Governance in Chapter 11…"). However, the obligations of a "debtor in possession" of a corporation, as the Board becomes under this situation (to the estate, creditors, preferred shareholders), is different and sometimes at odds over the trusteeship responsibilities of a Board in normal conditions (to the corporation and stockholders). These certainly become complex and challenging times for Board members. It may be that creditors will eventually have to take a percentage of the monies due to them in order to give the

organization the opportunity to continue. However, if the Board's plan for creditors is not approved by the creditors, then they can push the corporation into bankruptcy.

In charitable and not-for-profit circles, this same bankruptcy protection stage is not usually an option. So in these situations, the Board has to more informally see if creditors, bankers and other interested parties are willing to give them some time to turn things around.

It takes a strong will and significantly increased governance work, time, and personal sacrifice for Board members to work through bankruptcy protection period and then successfully reemerge. And it must be very tempting for some Boards to decide to forgo all this turnaround work and just declare bankruptcy - hoping to wash their hands of the situation as fast as possible.

Here we see how a few ounces of diligent governance work in the period leading up to such a decision might actually have prevented it?

The Declaration of Bankruptcy also causes all kinds of collateral damage:

- lost jobs for employees plus loss of business throughout the wider community, where the organization operated;
- no "transition" support to employees who need to find new jobs;
- pension, retirement & other benefits may evaporate;
- creditors who may go bankrupt themselves as a result of unpaid bills, or at least anger and suspicion towards working with the principal executives & Board members in the future;
- increased general scepticism towards the industry or other Boards/Governance groups;
- tarnished reputations of senior leaders & Board members;
- community outrage;
- disappointment, even potential hardship for customers, members who relied on the services provided by the bankrupt organization.

These divergent issues must be carefully weighed and documented in the lead-up to the declaration of bankruptcy to avoid lawsuits against individual Board members from the various parties affected by such a decision. Even then, those affected may still sue.

One of the more interesting current examples of an organization trying to stave-off bankruptcy is Air Canada. Like them or hate them, one has to admire the tenacity of their Board members and executives in re-thinking their business from the ground-up. They have negotiated successfully with creditors, found new investors, and worked with multiple unions to adjust pay, benefits, and working conditions.
This has undoubtedly been complex, tiring work for Board members and senior management alike.

They have successfully stared into the options to simply declaring bankruptcy, and "dug deep" to turn around the situation. They also had a lot of support from interested parties seeking to avoid the affects of bankruptcy.

As such, Air Canada can serve as an excellent example for all Boards – corporate and non-corporate – to follow in recognizing their trusteeship duty in the lead-up to a bankruptcy situation, and in re-engaging their other duties: duty to manage, fiduciary duty, duty of diligence & prudence, in order to actually avoid making such a declaration.

Unexpected, Large Financial Loss

Board members are routinely expected to pass the budget and business plan presented by management for the coming year. As such, a fulsome discussion of the budget and plan should occur between Board and management. Consideration should be given to:

- cash flow expectations;

- income assumptions and risks (sales, funding, etc.);
- expense assumptions – both regular and variable;
- foreign exchange & interest rate assumptions & risks;
- capacity of the organization's human resources to deliver plan elements on time, on quality, on budget;
- competency of the organization's resources to identify & implement innovations, growth elements, improvements as required and outlined;
- cash reserves to support the unexpected;
- nimbleness vs. restrictions in changing current commitments should conditions change (i.e. long-term contracts, leases, pension liabilities/assets).

Most Boards have also created policies around signing authorities and contracting/commitments limitations for executive officers of the organizations. Even beyond such authority levels, it is prudent and generally practiced that new, risky initiatives are presented to the Board in advance of commitment. These situations include:

- major expansion initiatives;
- entrance into new countries;
- lottery or other new fundraising initiative;
- stock/bond issuance.

Are these initiatives ever studied off-line by a Board committee, then fully presented to their colleagues with risks and questions identified for all to stimulate hearty discussion?

Or, are they routinely presented quickly by management on a packed agenda to the whole Board, with information provided in the Board package only a short time before the meetings?

Do all the Board members understand how to read financials? Do they understand the business well enough to identify and truly assess the risks?

Are new initiatives or changing business parameters tracked closely and red-flagged to Board members as conditions shift?

Do funders delay confirmation of funding levels well into the new budget year, causing significant problems if the funding is lower than expected?

Does management budget and build estimates conservatively leaving room for some slippage or are they expected to pull out all the stops, all the time by a Board trying to maximize results?

Again, a large financial loss generally has many months of warning signals and then provides several months for Board members to address recovery plans if there is honest, regular communication.
Potential trouble spots for Boards can arise from:

- non-existent or incoherent limitation policies;
- poor financial reporting format or formats that hide various initiative risks;
- CEO's/senior managers who are "prickly" to Board financial questions and risk enquiries;
- too many demands on staff/CEO such that reporting is incomplete and/or behind schedule (capacity);
- inexperienced or untrained management members leading new initiatives;
- inexperienced, untrained and/or poorly-read Board members such that they can't assess risk and ask good questions of management;
- delayed approval by Board of a Management-proposed initiative such that the window of opportunity closes and Management's success is compromised by the Board's inaction.

The bottom line: If the Board approves a new initiative or annual Budget, then they are just as culpable as management (perhaps more so) should failure occur!

Evaporating Member, Customer, Citizen Support

"Value shifts" are happening constantly in today's globalized world of work. This challenges corporations, governments, and 3rd sector organizations alike.

The Board's overarching concerns for sustainability and relevancy should therefore have them regularly interacting on a personal level with the community their organization serves. And, governors should be vigilant for such changes in the business plan assumptions presented by management.

Product, program, and service lifecycles are shortening constantly, such that the governors should be specifically attentive to the knowledge & innovation strategies for their organization.

What is your organization's growth strategy? Is it grounded in reality? Continuous growth (by the same product or service strategy) is an oxymoron as all products & services plateau in value & growth opportunity.

Perceived value of services provided by professional associations, programs from social service agencies, or even consumables such as toothpaste from manufacturing companies are constantly under attack from:

- consumers, constantly expecting more features for less cost;
- new competitors creating the next world class "mousetrap".

Even real estate values can shrink if the community doesn't attend to advancing safety, security, attractiveness, and desirability.

Of course, these trends can be seen and addressed if Boards have available to them information on such things as:

- # of members/clients;
- average profit/service or product-line;
- market providers;
- market conditions (growth, affluence, etc.);
- customer, member, citizen feedback reports.

Some of this can be provided by management, some may need to be purchased from independent 3rd parties (to avoid bias); some must come from general information/knowledge gathering by Board members themselves.

While a focus on financials is important, perhaps even more important is the Board's focus on maintaining and/or improving the <u>value</u> of their offerings to community. This will require specific discussions with management regarding:

- growth strategy;
- service array;
- knowledge & innovation initiatives;
- customer, member, citizen outreach.

Fraud or Regulatory Non-Compliance

Most of us like to be able to trust our colleagues, friends, and even strangers – until proven otherwise. Quite frankly, the alternative default position for living life is pretty depressing, worrisome and anxiety-producing!

As a result, the situation of fraud by a senior officer, white collar crime within an organization, or corporate non-compliance of regulatory conditions often comes as a shock to Board members.

Recent high-profile cases in many countries including politicians, executives, and charity fundraisers show that the Board must still be prudent in instituting policies & practices that will reduce such risk:

- art and furniture purchases, donations/sponsorships, and other assets policies – often requiring committee stewardship;
- rotating "spot" audits;
- whistle-blower programs/tip-lines (1-800 lines, websites, crime stoppers, etc.);
- Conflict of Interest policies, Codes of Conduct, Values Statements, Transparency Policies;
- clear expense & credit-card policies;
- awareness for individuals living beyond their means;
- regulatory compliance reporting to Board o;:
  - - tax reporting
  - - environmental practices/risks
  - - biohazard practices/risks
  - - "insider-trading" activity
- clear management accountability & performance management reporting.

Quiz Question – ***What is the # 1 reason in Canada for charities losing their charitable status?***
Answer – ***Failure to file their tax reports timely & consistently!***

This might seem like a lot of work for management in reporting to the Board. And similarly, this might seem burdensome to Board members to attend to such reports annually or even quarterly. Unfortunately, there are too many examples of problems resulting from lack of Management reporting and accountability to the Board. So, management will need to work with the Board to develop reporting format and frequency that will suit the Board's need to effectively discharge their duty of compliance.

Failed Leadership Transition

Sustainability – this number one responsibility of Boards has several components. Ranking right at the top is the need to:

- find, hire & motivate a competent, trusted CEO – to guide the day-to-day operations of the organization on behalf of the Board;
- recruit, train and support competent Board members to replace existing directors/governors so as to steward the organization into the future.

Both of these responsibilities can be accomplished through reasonable processes, with ample time to execute.

On the CEO front, if there is an existing CEO in place, the Board should ensure there is a succession plan in mind in the event of:

- upcoming retirement;
- resignation;
- accidental death or disability.

As the joke goes today, C.E.O. = Career Ending Opportunity!

Retirement is probably the most "controlled" of the three situations above. Often an heir apparent selection or external recruitment process can be started 12-18 months in advance of the existing CEO's departure. And, it is possible to construct an orderly, respectful transition and overlap period of say 3 months. This requires honesty of communications between Board & CEO and is usually highlighted in the Annual CEO appraisal process.

Succession planning can also be a part of the Board's H.R. Committee oversight work. Where this process can run into trouble is when the retiring CEO clings to power, and fails to be reasonable about an orderly transition.

Resignation: The resignation of a CEO is likely to happen due to:

- career progression/opportunity in another organization;
- results from a merger or downsizing;
- frustration with Board-CEO dynamics;
- poor performance;
- changes in family/personal life/health.

Today, the average term of corporate CEO's in North America is 7 years and shrinking. In the NFP sector, it is roughly the same, though there are usually not the same parachute/departure agreements. In government, Deputy Ministers often last approximately 2 years before they are rotated into a different portfolio. Given these statistics, the Board should be ever-aware of where their CEO is in their term dynamic, their career interests, performance against Board expectations, developmental needs and more.

The Board chair, along with any HR committee members or CEO Evaluation Committee members is likely to be the best to attend to this issue. In many cases, confidentiality should be respected with Board discussions held in camera.

Accidental death or disability is both tragic to the individual and family, and potentially disastrous to the organization. Well organized Boards and CEO's will have a crisis plan in place for this kind of situation. When Mark McCormack, founder & CEO, of IMG (the sport marketing company and author of : "What they Don't Teach You at Harvard Business School") died unexpectedly in 2003, executives there tell me that the Board and other senior executives went to a shelf in his office and opened up Mark's Action Plan for such an incident. It contained succession suggestions, restructuring suggestions and a To-Do list. Despite the personal tragedy, and the loss of the main force behind the organization, IMG didn't lose a beat. Here too is an excellent example for Boards to follow.

Board Succession: The old expectation that I grew up with in both management and Board service was: "Replace Thyself" In addition, it has oft been said that the sign of a good leader is that they have developed one or more potential successors and that the organization carries on well after they depart.

In today's setting for elected Boards or term appointments, turnover in governance is a regular reality to deal with. Some Board members openly declare that due to the election or appointment process (which they claim is beyond their control), they have no responsibility in this area.

To this attitude, I most respectfully disagree.

From a "politics" standpoint, they are correct. From a "governance" perspective, they are responsible for finding, developing and educating a cadre of potential replacements.

The stewardship responsibility of governance is that of a privilege to guide and shepherd an asset that does not belong to you, and then pass it on to the next generation that will also operate it in trust for the next generation, and so on.

Strategies for success in this area include:

- development of a "feeder system" for potential Board members through the creation of advisory committees;
- Board committees that comprise non-Board independent individuals;
- public/member education through media advertisements regarding the requirements for successful Board members, knowledge/experience expectations, etc.;

- offsetting Board terms such that new Board members work along-side experienced governors;
- Past Chair position to aid in knowledge/experience transfer to new Chair.

Conclusion

Acting as a Board-member or Governor in the best interests of an organization is becoming more, and more challenging. The implications of poor governance, or more likely, incomplete governance can be staggering. While I hope none of the readers of this article, ever find themselves in the situations described above, hopefully the raising of these examples and practical suggestions to avoid these problems, will help Board members do a better job.

Whether paid or unpaid, doing governance work is a serious job, with rising expectations and standards. If we don't do the work, *Nobody* will…! The glory is usually modest if not invisible, the tangible rewards generally a lot less than the time and dedication required. So it is with a real sense of service, and higher calling of stewardship that we should take on these roles and do the best job possible, in order to pass on healthy organizations, providing solid, valued products, programs and services to the next generation of Board members when we are finished.

Exploring the Web!

This month, the connections below take you to sites with more perspectives, commentary and examples of Governance blunders.

http://www.cbs.gov.on.ca/mcbs/english/5HZPQG.htm
Ontario Ministry of Consumer & Business Services – Questions & Answers: Company Information for Annual Returns.

http://www.thelenreid.com/articles/article/art_152.htm
Thelen Reid & Priest LLP – Summary of the California Corporate Disclosure Act regarding information of Board members.

http://news.bbc.co.uk/1/low/business/2313091.stm
BBC News story on EOTT Energy Partners, and Ex-Enron Oil unit filing for bankruptcy

http://www.vscpa.com/PR/Non-Profit/liability.htm
Responsibility and Liability of Board members of Nonprofit Organizations.

http://www.t-tlaw.com/np-02.htm
"The Key to Nonprofit Organizational Governance", from Thompson & Thompson corp. The first of a 2-part article. (Follow the link to second part.)

http://www.pattonboggs.com/Newsletters/bankruptcy/Release/2003_articles/2003_07.htm#1a
Corporate Governance in Chapter 11 and Stockholder Voting Rights: Who's In Control? Patton Boggs LLP

http://www.post-gazette.com/pg/04139/317850.stm
"Failure to Prepare for Leadership Transition is Common" Experiences at Coca-Cola.

Banff Executive Leadership Inc. offers public and customized programming to improve Board Governance and Executive Leadership Practices. We also provide coaching and consulting services to Boards and Executives to help enhance their leadership practices. Please contact us if we can be of further assistance.

If you found this article useful, please forward the article's web link to a friend!

www.banffexeclead.com