

The changing world of
corporate governance
A best practices guide for boards
to address M&A, corporate crisis
and financial distress



The parameters of governance are changing

The board just learned the company may face a cash shortfall within the year. What should you do? After a company is acquired, the board is sued by shareholders alleging inadequate oversight regarding the acquisition price decision. How could this have been prevented? Your company is in crisis after management is accused of providing false information to external auditors. When is it time to seek third-party advice?

Much has been made of the pressures facing boards of directors in the still-roiling wake of the global financial crisis. There has been plenty of blame to spread around, with financial deregulation, inadequate audit procedures, investor overconfidence, flawed lending practices and corporate greed all being cited as factors. Boards were not immune to this examination, with pundits wondering if more effective oversight on the part of financial institution boards might not have identified and brought forward some of the issues that almost collapsed the global economy. Did boards have enough members with the right kind and level of insight? Did they ask the right questions? Did they take the right steps? Were they up-to-date on emerging issues? Were they willing to challenge management? Of course, in retrospect the financial crisis is largely viewed as something of a perfect storm of causes, with no one component or entity entirely to blame, and remediation measures are still being applied across the regulatory and corporate spectra. The questions that were asked, however, continue to resound for boards in general. Indeed, as we move beyond the financial crisis, they are being asked of boards in a number of other areas and around a range of potential risks and responsibilities.

The last five years have seen massive changes in the global regulatory environment. Many industries saw increases in the volume and complexity of regulations, as well as the stringency with which they are enforced; and companies, reeling from a range of post-crisis impacts and keen to limit risk wherever possible, are

struggling to keep up. Boards, for their part, are also trying to keep pace, even as stakeholder, regulator and public expectations shift beneath them.

What has this meant for the average board member? Pressure on multiple fronts. For example, serving on boards, especially for those with multiple directorships, can become unmanageably time consuming and increasingly risky from a director's liability perspective. The amount of regulatory and specialized knowledge required to be an effective board contributor is growing, and members are often overtaxed by their broadening scope of duties.

Clearly, boards today are in a very challenging position. Given their broad mandate, they must keep track of a growing range of information, adopt new response strategies to fulfill their mandate and determine when to consult third-party experts when specific circumstances arise.

This paper is designed to help today's highly challenged boards. Looking at three critical areas that do not often receive the board attention they require – M&A, corporate crisis management and financial distress – it examines the key risks boards should consider in each area, offers steps boards can take to address these issues, and reviews the benefits of improved board oversight and the dangers of prolonged inattention.

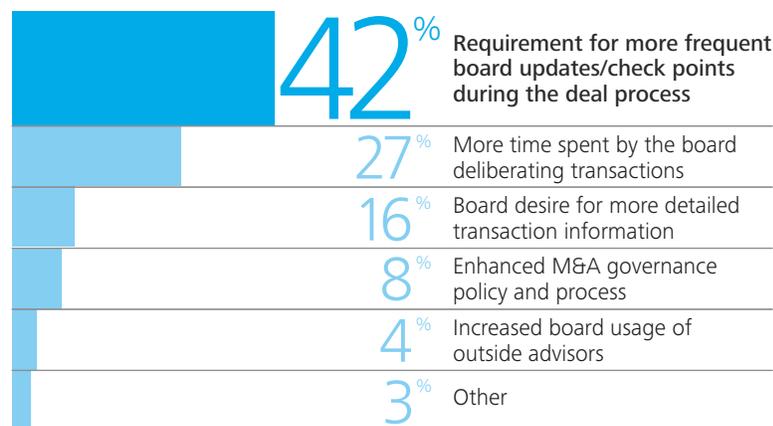
M&A – good governance covers every stage of the process

Most agree that the current economic environment has intensified pressure on boards to be more engaged in managing enterprise risks, in particular those introduced by M&A.¹

Many M&A deals – seven out of ten – deliver negative returns. These success shortfalls can be rooted in a variety of factors – from selecting the wrong target to poor integration execution. While the reasons for failure vary deal to deal, a common thread is that good governance could have gone a long way towards mitigating or preventing the eventual challenges. As such, boards must – and are increasingly expected to – play a larger role in overseeing the entirety of the transaction process, particularly for large deals that have the potential to transform the landscape of a business and its industry. The role and extent of board member involvement in a given transaction depends on the nature of the deal. It may be common practice to keep the board regularly updated through status report updates and

check-in points throughout the process, but often this is not enough. For example, some boards are still not sufficiently involved in corporate strategy and understanding M&A's role in it; they do not pursue multi-disciplinary due diligence; and they may not provide sufficient oversight of integration. Essentially, the board's role in the overall M&A process is frequently too piecemeal. Their processes are incomplete, and as a result, the risk of transaction failure is heightened. However, a board member's exposure goes beyond just the negative image implications of failed deals. Insufficient governance in the context of a deal gone bad puts board members at risk of being sued after-the-fact because the oversight process had too many gaps.

Most significant ways board involvement in M&A has increased²



¹ Deloitte. Corporate Development 2012: Leveraging the Power of Relationships in M&A.

² Deloitte. Corporate Development 2012: Leveraging the Power of Relationships in M&A.

Board best practices must permeate every aspect of the M&A process

There are, however, certain best practices boards can implement at every stage of the deal process to ensure end-to-end good governance. For example, boards understand that they need to oversee development of the corporate strategy and its M&A sub-component, ensuring M&A goals align with overall strategic direction and outlining the criteria of a successful deal. From there, however, they must revisit that strategy regularly to ensure management remains on track and determine whether strategic change is in order. Whether or not growth through acquisition is a cornerstone of your strategy (or divestiture part of your portfolio strategy), you still need an M&A strategy in case opportunities arise, and when that happens, the board must be prepared to make sure management considers all the necessary issues.

Along with strategy, there is a sequence of best practices boards can follow – on both the buy and sell side – to ensure good governance throughout the entire deal process. Directors should:

Buy-side

M&A strategy

- Ensure M&A is aligned with overall strategic direction
- Monitor management's communication of strategy
- Deliberate management's success criteria
- Refine M&A strategy on an ongoing basis

Transaction development

- Define acquisition criteria with management
- Define and execute approval process for approaching specific targets
- Determine conflicts of interest and establish a special independent board/committee
- Consider and approve external advisors
- Ensure the organization is prepared to handle the transaction

Due diligence

- Request detailed diligence around a proposed deal's fit with corporate strategy/valuation
- Ensure management sufficiently undertakes all aspects of due diligence
- Understand/challenge the type, amount and likelihood of potential revenue and cost synergies
- Help steer through unforeseen complexities

Transaction execution

- Review management's valuation
- Critique how management will access more post-transaction value
- Establish a clear negotiating range for bids
- Ensure proactive communication among stakeholders

Integration

- Ensure integration leadership and project management are in place
- Review the integration plan, identify risks and ensure integration focuses on value drivers and mitigates issues in advance
- Ensure M&A strategy and due diligence results influence integration efforts
- Track synergies against the defined targets and challenge areas that seem to be lagging
- Review and approve communications

Sell-side

M&A strategy

- Oversee an M&A strategy that focuses on the sources of value
- Ensure M&A is aligned with overall strategic direction
- Monitor management's communication of strategy
- Deliberate management's success criteria
- Refine M&A strategy throughout market and company cycles

Prepare the business for sale and pre-sale due diligence

- Establish M&A policy and governance
- Encourage regular, complete, high-quality information updates
- Begin networking/relationships with potential buyers
- Provide deal advice/counsel to management
- Evaluate and challenge management's transaction objectives
- Consider and approve external advisors
- Oversee necessary changes to compensation plan

Marketing and buyer selection

- Define and execute approval process to approach and select specific buyers
- Critique how management will access more post-transaction value
- Suggest potential buyers
- Ensure ongoing communication/updates
- Commission a fairness opinion, if required
- Establish clear negotiating range when taking bids

Closing the deal

- Ensure a proactive communication plan that targets relevant stakeholders

By finding ways to help management pursue deals and mitigate related risks, boards can add genuine value to the M&A process.



Case study GrainCorp Australia Limited

Challenge

GrainCorp Australia – an ASX 100 diversified agribusiness with grain, malt and flour operations in Australia – is an active player in the global commodities trading markets. The company was pursuing a diversification strategy to reduce exposure to drought-exposed crops in all major growing regions of the world. As part of this initiative, they assessed acquisitions in the edible oils space and closed in on a transaction that would involve both the collection/crushing segment and the refining segment of the value chain. In August 2012, the company announced an A\$472M acquisition of two assets: Gardner Smith, a long-standing aggregator and crusher of canola (including trading operations), and Integro Foods, an established oils refining business that was fully integrated within an ailing Australian food processing business. The transaction was transformative in nature as it represented a complete new line of business for GrainCorp. To compound the challenge, the company had only an average record in managing integrations, and the leader of the new business unit was their former leader of trading operations. All these factors prompted the Chairman of the Board to agitate for external advice to support the project.

Solution

The chairman of the board instigated a meeting between Deloitte integration advisory partners, the designated integration lead and the designated Business Unit leader from GrainCorp. The chairman's initial concerns were soon validated by the business representatives, who felt overwhelmed

by the scope of the task. The Deloitte team provided the board with a structured, coordinated Day 1 readiness approach that mobilized a team of 35 functional and business leaders across the three organizations along a common goal – making Day 1 a non-event and planning the integration effectively. With the chairman personally participating in workshops and sessions, the team passed the milestone without incident, and an Australia – and New Zealand – wide road show was launched on Day 1. Subsequent integration planning and management efforts put GrainCorp Oils division on course for success in its key markets.

Outcome

The merger of two complementary and partly competing businesses in the Australian edible oils sector was managed without any upset to ongoing business. In addition, a focused effort to quickly lock in synergies across all categories had the integration on track to exceed its A\$7M p.a. synergy target. Nine months after Day 1, GrainCorp's board chair and CEO together provided the following update to shareholders: "The result reflects the benefits of the company's diversification strategy. GrainCorp Oils' solid performance is ahead of our expectations, and the integration is proceeding well. I'm pleased to report we have achieved our FY13 pre-tax synergies target of \$4 million and remain on track to deliver \$7 million of annual synergy savings."

Going beyond – a board’s role in transformational M&A

Every day we hear about new deals occurring in the marketplace as companies move to strengthen their core businesses. The less risky nature of these transactions can allow board members to take comfort in good governance that follows a basic “check-the-box” process, ensuring management is undertaking best practices to get the most out of the deal.

But every once in a while, a company will engage in a deal that is so monumental that it changes the way the business (and its industry) operates. It is for these transformational M&A activities that board members must think beyond applying simple due process, and leverage their long-term perspective and wisdom to truly add value to the contemplated transaction. It is consequently imperative for board members to consider the following when these high-risk deals are at play:

- Critically challenge management to explain why the deal fits with the long-term strategy of the company

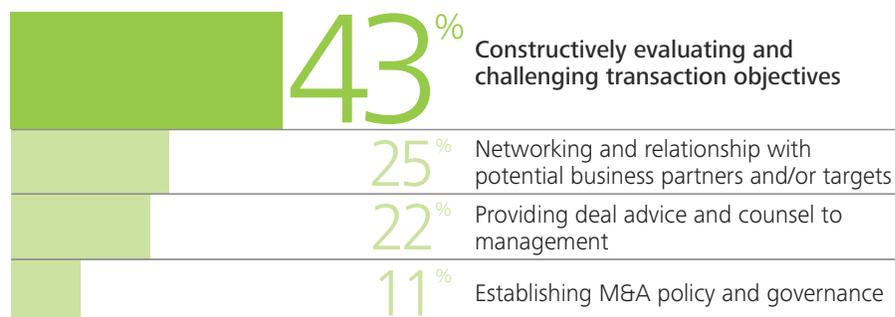
- Understand the worst-case scenario if the transaction does not develop as expected, and ensure management has a plan of action ready should it fail
- Ask the tough questions that no one wants to ask

Board involvement can deliver genuine competitive advantage

According to a recent Deloitte survey, boards are beginning to deliver more value to the M&A process.

As cross-border M&A deals become more common, the global regulatory landscape becomes more complex and economic uncertainty puts a premium on realizing post-deal value, boards should look at increasing their M&A oversight contribution. The negative impacts should this not occur – reputation damage, potential law suits, the cost of failed integration and more – can be serious. On the other hand, a board that consistently helps management effectively execute on its M&A strategy contributes directly to the development of a significant and sustainable competitive advantage.

Greatest value added by the board of directors in M&A



Critical board considerations for any M&A initiative

Buyer's checklist

- ☑ **Establish an M&A strategy that focuses on the sources of value.** Increased efficiency, improved market power, or, corporate reinvention.
- ☑ **Stay true to that strategy.** Ask yourself why you're in the game, if you can't come up with a justifiable answer, don't play.
- ☑ **Focus on potential synergies.** Determine buyer-specific synergies and negotiate accordingly. Actually quantify the cost savings you expect to achieve, don't waiver, and don't pay for value you bring.
- ☑ **Take a holistic approach to due diligence.** Don't look at it simply as a legal and financial exercise. Effective due diligence can have a tremendous impact on your ability to integrate the new organization.
- ☑ **Plan and structure for integration early on.** From day one, you should be planning to minimize the pain and maximize the benefits of integration. Because even the best deal can fall down based on how well you integrate.
- ☑ **Focus on speed of integration – because speed matters.** Define your end-state and plot a roadmap with clearly defined – and immovable – deadlines for tangible results.
- ☑ **Focus integration on clearly defined drivers of value (e.g. head count reduction).** Create a value matrix – one that identifies all of the drivers of value – and prioritize your activities based on what will deliver the most benefit.
- ☑ **Align organizational goals and responsibilities and address retention issues early and often.** Reward the people you want to keep on board – and resolve to make the difficult decisions about people who might not work in the new organization. Focus your efforts on creating a shared culture.
- ☑ **Communicate throughout the M&A lifecycle.** Telling your story the way you want it told prevents others from telling it the way they want to tell it. Control your message – and communicate it often.

Seller's checklist

- ☑ **Focus more on strategic, rather than financial considerations.** Divestitures need to become part of a core strategy rather than simply a way to improve finances in response to negative events. All business lines need to be systemically tracked for the economic value they are adding to the enterprise.
- ☑ **Be a prepared seller.** Careful preparation, including approaching the sale from the buyer's perspective, is important to increasing transaction value and reducing time-to-close.
- ☑ **Allow time to create a competitive auction.** Don't rush to auction your business, rather allow time for buyers/investors to pool, which will help to optimize the value of a sale.
- ☑ **Focus on seamless carve-out.** Prepare your business for sale and know what the company is going to look like after the divestiture is complete.
- ☑ **Don't wait to consider change.** Remain open to divestiture opportunities, even when your business is running well.
- ☑ **Learn to manage TSAs/stranded costs.** Transaction Service Agreements (TSAs) are viewed as a necessary evil by many companies, but they can be used as a strategy to close details. Plan for them by developing accurate costs, defined service levels, and detailed exit plans.
- ☑ **Timing is everything.** Know the key factors influencing the industry's cycle and time your divestiture accordingly.
- ☑ **Know the buyer.** Have a clear understanding of how your business is going to add value to the potential buyer/investor and what synergies they expect to achieve.
- ☑ **Communicate throughout the M&A lifecycle.** Telling your story the way *you* want it told prevents others from telling it they *they* want to tell it. Control your message – and communicate it often.
- ☑ **Remember the people.** People retention becomes critical during divestiture. Have a clearly defined plan to retain and mobilize talent through the transaction.

Corporate crisis management – lack of preparation presents a clear risk

According to a recent crisis preparation study, nearly 80% of business leaders predict their company will experience a crisis within the next year. Despite this, only 54% of participating companies had a crisis plan, and about half of those plans were deemed insufficient.³

You may or may not see a corporate crisis coming. In some cases there are signs that an organization may be vulnerable to a crisis, such as internal control weaknesses or a pattern of poor financial results. In other cases, an organization might be caught completely off guard when a crisis strikes; consider a natural disaster or a front page corruption scandal. In either case, having a plan for how to deal with a crisis when it strikes is critical to overcoming it. Boards of directors play a key role in crisis preparation – few other individuals within an organization have the level of oversight, experience and independence necessary to see a company through a crisis.

Consider the listeria crisis that struck Maple Leaf Foods in August of 2008. The bacteria, introduced into food products in one of the company's packaging plants, resulted in 22 Canadian deaths and numerous illnesses. The loss in revenues – combined with out of pocket costs related to recall and destruction of products, sanitization of plants and public relations – caused Maple Leaf's operating profits to fall by 93% to a net loss position in the third quarter of 2008.

The consensus among media and crisis management experts is that Maple Leaf addressed the tragedy with a powerful combination of rapid response, specific measures and reforms, heartfelt apology and strong executive leadership, resulting in both public forgiveness and a rapid return to profitability. The Maple Leaf board had developed and implemented a strong crisis response strategy which they executed promptly and convincingly. By 2009, the company was profitable again, reporting earnings of \$22.5 million in the third quarter.⁴

Maple Leaf Foods presents an excellent example of crisis planning in action, but organizations need the ability to respond to many forms of crisis. If the RCMP shows up at a company's headquarters to execute a search warrant, would employees know how to respond? Who to direct them to? What to do? If an organization makes front page news for allegations of fraud, how quickly can the appropriate individuals convene to hammer out a strategy?

³ "Prepared for a Crisis?" in *Tone at the Top*, Issue 61, April 2013. The Institute of Internal Auditors.

⁴ The Toronto Star, Oct. 28, 2009. "Maple Leaf Foods recovers from listeria crisis." Accessed at http://www.thestar.com/business/2009/10/28/maple_leaf_foods_recovers_from_listeria_crisis.html on January 20, 2014.

Crisis roadmap – responding to immediate crisis needs

As crises are unpredictable by nature, there is no one-size-fits-all solution. But there are some basic steps that are likely to be effective in most, if not all, crisis situations.

A crisis roadmap like the following can be used both in planning for and responding to a crisis situation.

Defining the crisis

Naturally, what constitutes a “crisis” varies by organization. As such, the first step of developing a crisis management or response plan is to apply some parameters around what types of situations are considered a crisis.

Directors should:

- Maintain a working understanding/definition of what constitutes a “corporate crisis” for the organization
- Define the varying levels of escalation within the organization, including responsibilities for management and oversight of the response

Understanding the risks

Differentiating between a corporate crisis and an operational issue can be simplified by adopting a risk-based approach. Identifying, evaluating and ranking potential risk is routine for most directors. This ongoing risk assessment process can be leveraged to develop a working definition of crisis that is tailored to each organization.

Directors should consider the following types of risk:

- **Reputational risk** – will company reputation be affected and on what scale?
- **Market impact** – will share prices be affected?
- **Litigation risk** – is there danger of a class action suit being launched?

- **Going concern risk** – could you actually go out of business?
- **Regulatory risk** – will the securities or other regulator, police or the courts become involved?
- **Personal risk** – does the board, or any individual director, have significant personal liability risk?

Determining accountability – external stakeholders

Directors should determine to whom the organization is accountable, in addition to its shareholders:

- **Shareholders** – the timing and nature of disclosure in such events is always subject to much debate and opinion. It is critical, with often competing considerations including the potential for class action litigation.
- **Regulators** – if a crisis results in a regulatory issue, the organization will likely need approval from regulators to fully remedy the situation. Consulting with regulators early will help ensure that a crisis plan or response addresses all regulatory issues, and will also demonstrate an attitude of openness and an overall culture of compliance.
- **Criminal authorities** – violations of the law are investigated and enforced by law enforcement authorities, with whom an organization may not have an established relationship. Input from legal counsel is crucial in planning for and responding to a crisis situation involving criminal authorities. The company itself may have criminal liability, along with individual employees, depending on the situation.
- **Customers** – if customers are affected by a corporate crisis, a strategy for customer communications and relations is likely necessary. Considerations include whether customers will be dealt with on an individual basis or in groups and what information can, and cannot, be released.
- **Auditors** – a corporate crisis may have implications for an organization’s auditors, and understanding how an audit is affected is an important consideration.



An organization's relationship with its external stakeholders can make the difference between a slow and painful experience and one where the board has the most control possible in the circumstances. In the event of a crisis, some external stakeholders may conduct an independent investigation, which will likely require cooperation from the organization. In both planning for and responding to a crisis situation, consider the strength of relationships with external stakeholders and the frequency and nature of communication.

Assigning responsibility – internal stakeholders

In planning for or responding to a crisis, a key consideration is who should be involved in these processes.

Directors should consider the extent to which they should involve:

- **Employees** – a crisis situation is unlikely to be resolved without rallying the troops – and their strength will be tested. As the eyes and ears of an organization, employees are critical to both planning for and responding to a crisis, and a sufficiently broad population should be consulted for input. A crisis management or response plan should be flexible and able to adapt based on the circumstances. For example, individuals that are delegated responsibility in a crisis situation may have had some involvement in the factors that led to the crisis, in which case their participation may be inappropriate.
- **Board committees** – where the size of an organization warrants, a board may already have natural delineation of responsibility among board members. In planning for or responding to a crisis situation, the board should consider if a special or independent committee is necessary to resolve the situation. It is the norm that special committees are struck to deal with corporate crises, usually involving the independent directors.

Evaluating capabilities

Directors should consider:

- How will board oversight of the crisis response be structured?
 - Is a special or independent committee necessary?
 - Does management have the expertise and independence to deal with the crisis?
 - If no, who will retain expert external advice: the board or management?

- In either of the above cases, who will prepare/contribute to the crisis plan and response?
 - **Legal** – internal/external counsel. Considerations include the actual existence and appearance of independent legal advice from internal or external counsel (is it appropriate to use the company’s normal external corporate counsel?)
 - **Forensic accounting investigators** – an independent third party
 - **Auditors** – can they be involved?
 - **Industry** – to provide core technical background and information
 - **Public relations** – to manage the media storm
 - **Other**

Preparation is the best response

If crisis strikes – for example, a criminal investigation – what you do in the aftermath is as important as being prepared. In this situation, it is not unusual for boards to review the company’s internal controls to determine how the crisis began and what more you could have done to prevent or manage it. From there, it is important to ensure there are policies and procedures in place to prevent similar occurrences going forward. You cannot anticipate every crisis, but you should implement a structure that is flexible and adaptable to different situations, for example, one that has built-in options for when management can be involved and when it cannot. To address the full range of potential crises, you need alternative solutions that fit multiple situations. You should also make sure, however, that a strong response mechanism does not become a substitute for proactively implementing policies and procedures before a crisis occurs. Above all, maintain a roster of specialists you can call the minute a crisis arises.



Case study Siemens AG

Crisis

In 2006, German technology giant Siemens AG was rocked by allegations of bribing foreign officials on an unprecedented scale. Beginning in November of that year, the Munich Public Prosecutor's Office (MPPO) carried out searches at the homes and offices of numerous Siemens employees, including the acting CEO. The raids were conducted at over 30 locations in multiple German cities and resulted in six arrests. By the conclusion of the raids, the MPPO announced it had uncovered \$257 million in illicit payments and commissions, facilitated through the use of slush funds and falsification of accounting records, resulting in over \$1.1 billion in profits to the organization. In the following days, the company's share price tumbled amid the threat of ongoing regulatory probes.

Response

Within weeks, the then-Chairman of Siemens' Audit Committee convened a meeting with key representatives from the company's board, management and external auditors. The participants made a pivotal decision to conduct an extensive internal investigation into the allegations, in anticipation of ongoing investigations by both the MPPO and the U.S. Department of Justice (DOJ). On December 11, 2006 the Audit Committee voted to retain a New York-based law firm, with a mandate to report directly to the Audit Committee. By April 2007, the board had established an independent Compliance Committee to oversee the investigation. Deloitte's team of forensic accountants were retained by the lawyers to conduct an international investigation spanning two years and involving

over 1,500 interviews, the review of over 10 million documents and the analysis of over 35 million financial transactions. The investigation uncovered approximately \$805 million in corrupt payments and led to a substantial remedial effort, under which Siemens developed and implemented a comprehensive, entity-wide compliance plan.

Outcome

By December 2008, Siemens had settled claims with both U.S. and German prosecutors, for a combined total of approximately \$1.6 billion. In November 2009, a further settlement of \$100 million was reached with the World Bank in relation to Siemens' Russian subsidiary, which was debarred by the World Bank for a period of four years. The board's decision to invest in a thorough internal investigation administered through an independent sub-committee factored heavily in the calculation of fines by both regulators and the World Bank. In its Sentencing Memorandum, the U.S. DOJ specifically cited Siemens' "exceptional cooperation" and comprehensive investigative and remedial efforts. While the impact of both the fines and the investigation costs significantly impacted the company's profitability and share price in the short term, Siemens remains an exemplary model of board conduct in a time of crisis, and highlights the critical need to balance potential risks with an appropriate response. As a result of these efforts, Siemens has rehabilitated its reputation, is no longer barred from World Bank projects and is viewed as a leading example of best practices for anti-corruption compliance.

Financial distress – risk is front and centre

Most boards are fortunate to govern profitable enterprises where truly crippling financial issues are a rare occurrence. As a result, boards can be caught off guard when a company enters financial distress and may struggle to mitigate the issues that arise. This is problematic because, in times of financial distress, proactively managing and mitigating risk is vital.

The risk implications of financial distress

If you sit on the board of a company in financial distress, levels of personal and corporate liability increase, which means you need to exercise a higher level of oversight and diligence to both protect yourself and best represent the company. When things are going well, the board is most focused on its responsibility to shareholders. When the organization enters a state of financial distress, however, the umbrella of responsibility and accountability of boards should broaden to other stakeholders. Large lenders and other significant investors may be able to offer

additional funding or help work out debt options, so being accountable, maintaining a relationship and communicating effectively with those parties is, for example, both necessary and sensible.

When companies face a resource shortfall, they generally take measures to reduce financial outflow. If those measures affect certain areas – for example, wages, pension contributions, tax remittance, environmental responsibility – directors may face a range of personal liability issues, with different penalties depending on the infraction.



When an issue resulting in an enterprise risk factor presents itself to the board, each director must consider one question: “Is the board doing enough to mitigate the risks faced by the company?”

Sources of potential director liability

Corporate finance risks

- **Issuance of equity for assets or services.** Potential liability for shortfall between non-cash consideration received and Fair Market Value of cash value of equity.
- **Payment of dividends while insolvent or rendered insolvent by the payment.** Potential liability for dividends plus interest.
- **Share purchases/redemptions while insolvent or rendered insolvent by the payment.** Potential liability for amount paid plus interest.
- **Failure to disclose and address perceived/ actual conflicts of interest.**

Pension risks

- **Company pension plan (employee contributions).** Potential liability for employee contributions deducted, but not remitted.

Environmental risks

- **Prevention of contamination.** Potential liability for failure to identify a contamination scenario, notification of relevant regulatory bodies, and remedial costs.

Bankruptcy risks

- **Bankruptcy offences.** Potential liability from sections 198 and 204 of the Bankruptcy and Insolvency Act in certain scenarios, including but not limited to the following:
 - Fraudulent dispositions of property
 - Making false statements or materials omissions
 - Fraudulently conceals or removes property
 - Refuses or neglects to answer fully and truthfully all proper questions
 - Failure to keep proper books of account
 - Unlawful transactions

Taxation and source deduction risks

- **Indirect taxes not remitted.** Potential liability for unremitted amount.
- **Employment Insurance premiums deducted, but not remitted.** Potential liability for unremitted amount.
- **Federal income taxes.** Potential liability in certain scenarios.

Employee risks

- **Unpaid wages.** Potential liability for up to six months' wage.
- **Unpaid vacation pay.** Potential liability for unpaid vacation pay accrued within the past 12 months.

Knowledge reduces risk

If cash flow is declining, when will it actually run out? Is your debt about to mature and require renewal? The board is removed from day-to-day operations of a company, so to answer these types of critical questions, directors must rely on management to tell them what is really going on inside the business. There can be issues in this process – in private companies, for example, sometimes the CEO is too close to the business and in denial; or management may simply be lax in reporting or using an ineffective or inaccurate system. But if management reports effectively, the board should have the forewarning they need to respond to looming financial distress. Boards are extremely well-versed at looking at cash flow requirements, debt and financial risk issues. Knowing when those issues fester and determining when a company passes a threshold into a state of financial distress; knowing what to do when that happens; knowing how both the company and individual directors may be affected; and being prepared to go on record that you believe trouble is brewing will make the difference – in the company's well-being and in your ability to manage and mitigate director liability as well.



To get the right answers you need to ask the right questions

Early and pragmatic action can minimize risks and liability for both the company and the board. Start with these key questions when your company is in financial distress:

1. Has management recognized and acknowledged the real issue, and are they actively engaged in resolving the situation and mitigating risk?
2. Does the board fully understand the unique risks and potential implications financial distress brings?
3. Different risks require different information – does the board have the right information to understand the problem and govern accordingly?

Financial distress risk factors and steps toward mitigation

When a company enters the zone of insolvency – essentially, when a company’s liabilities exceed the fair market value of its assets or its debts cannot be settled as they become due in the normal course of business – personal liability for directors could result, and the company’s in-house resources may not include the necessary financial planning knowledge or legal insolvency experience to identify and mitigate the risks.

To better understand director-related impacts of insolvency, it is important to review the following financial distress issues and remediation steps. Directors should:

Declining corporate performance

- Become increasingly vigilant and engaged as enterprise performance declines
- Act as soon as possible to best address the issues and mitigate risk
- Ensure that board oversight and monitoring procedures are functioning properly and that management provides relevant information
- Ensure management understands the degree of financial distress and develops a turnaround strategy and action plan

Cash flow and liquidity crises

- Determine how long financial resources will let the company operate
- Ensure scenario planning has been used to forecast and analyze potential events critical to cash flow and liquidity management
- Ensure management identifies material liquidity risks and actively monitors cash and working capital
- Consider the risk of bias in cash flow forecasts

Unsuitable and/or unsustainable capital structure

- Meet regularly with large stakeholders to develop strong relationships

- Question if the company has valued leverage over financial stability
- Ensure management is aware of any signs of shareholder activism
- Actively and regularly monitor the company’s capital structure
- Consider short-term reduction or elimination of any dividends
- Ensure board notification of changes in the company’s shareholder base

Exposure to foreign jurisdictions and related risks

- Ensure board and management understand all jurisdictionally-based risks
- Understand local laws, regulations and business practices
- Encourage strong relationships with key local stakeholders
- Understand the risks associated with cross-border cash flows
- Ensure management understands corruption issues in emerging markets

Enhanced risks to directors of companies entering the zone of insolvency

- Enhance legal knowledge with restructuring, turnaround, insolvency and bankruptcy specialists
- Review D&O insurance policy coverage and limits
- Be sure they are aware of the enhanced risks they face

Inability of the board to adequately provide oversight for companies entering the zone of insolvency

- Ensure management provides accurate, relevant, timely information
- Consider forming a committee to monitor liquidity and other urgent issues
- Learn the business as if they had to manage it, so they can challenge management effectively
- Ascertain that key performance and insolvency indicators are being tracked

Directors lack confidence in management's abilities to lead turnaround initiatives

- Question whether CEO and management can effectively lead a turnaround
- Consider engaging a financial advisor or Chief Restructuring Officer to lead the corporate turnaround
- Review management strengths, weaknesses and capabilities
- Consider forming a committee to review/monitor initiatives

Directors lack confidence in the company's contingency plans

- Engage industry specialists to "reality check" contingency plans, ensuring they include short-, mid- and long-term risk measures
- Assess potential management biases (toward legacy business practices, revenue growth over strategy, etc.) in relation to decision making
- Consider all options, such as divestiture, strategic options analysis, head count reductions and dissolution of unprofitable business segments





Case study Global Real Estate Company

Challenge

A real estate holding and development company – with approximately \$2 billion of assets consisting of approximately 200 commercial, industrial and high-density residential properties in Canada, the U.S. and Europe – was experiencing depressed property market values and high vacancy rates due to the financial downturn. This created a cash flow crunch where the company was unable to settle its liabilities as they became due. At the same time, the weak market prevented them from raising capital, selling assets or obtaining additional financing. Increasingly strained relationships between stakeholders were stressing the organization and hampering internal mediation efforts.

Solution

The board recognized that the company had entered an advanced stage of financial distress and that action on their part was necessary. The board promptly established a special committee to review their strategic options and determine proactive steps for dealing with the cash flow crunch. To get the information and knowledge they required, the special committee engaged Deloitte to provide advisory services and recommend initiatives to improve cash flows, restructure company debt and develop contingency plans for a formal restructuring, should it be necessary. A cross-functional, geographically diverse team of real estate, capital advisory, valuations and restructuring professionals undertook the following in support of the board's decision-making process:

- Reviewed cash flow projections and undertook strategic options analysis
- Performed a detailed review of real estate holdings and related liabilities
- Analyzed the company's debt and equity options
- Developed recommendations to present to the board
- Assisted management in its responses to the securities regulator and other key stakeholders

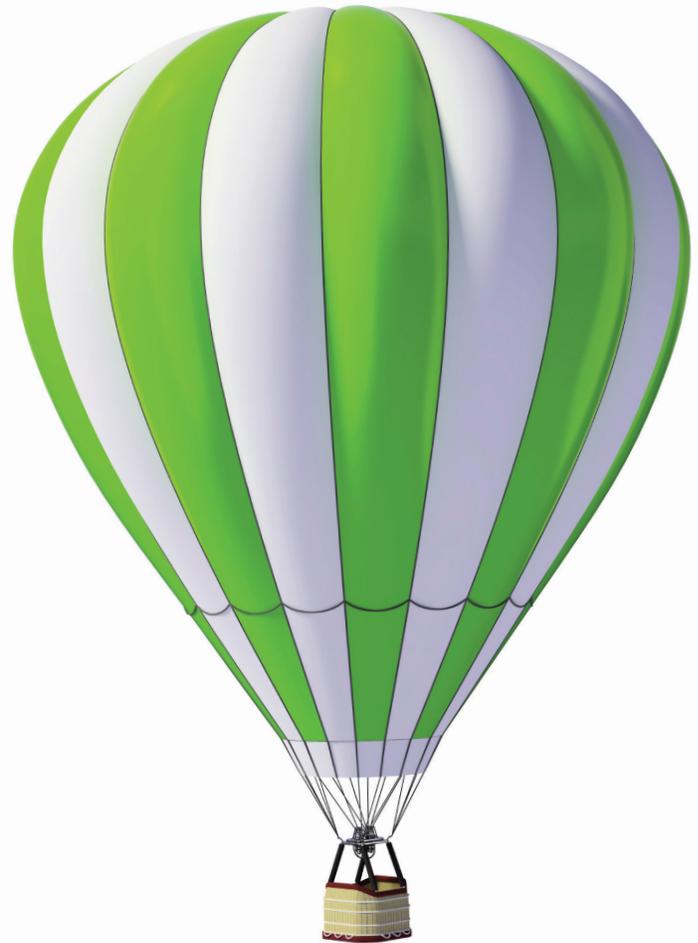
Outcome

The Special Committee provided the board with recommendations based on Deloitte's independent, third-party analysis that improved their decision-making position, for example, when determining if a CCAA or other insolvency filing was in the best interest of the company. The board was able to fulfill its duty to protect stakeholder value (creditors as well as shareholders) and demonstrate that management was actively addressing the situation. A successful Plan of Arrangement helped maximize creditor returns, and director liability was reduced under certain scenarios.

Boards can rise to the challenge

There is no question – boards fulfill an extremely difficult role. Directors have serious, far-reaching obligations and their duties can be broad and complex. As a result, board members sometimes struggle to keep pace with new regulations, meet shifting stakeholder expectations and find the answers they need.

We hope this best practices guide has illuminated some key areas that are not always at the top of the board agenda, but that can have huge impacts on companies and their directors. Knowing the full extent of your responsibilities and developing specific steps for carrying them out can help you better manage the expectations and demands directors face and exercise your oversight duties with maximum effectiveness and risk awareness going forward.



Contacts

For more information about how Deloitte can help strengthen the governance capabilities of your organization please contact:

Board Advisory

Bill Stamatis

Partner

416-601-6733

bstamatis@deloitte.ca

M&A

Mark Jamrozinski

Partner

416-601-6499

mjamrozinski@deloitte.ca

Corporate Crisis

Alan Stewart

Partner

416-643-8289

alastewart@deloitte.ca

Financial Distress

Adam Bryk

Partner

416-643-8252

abryk@deloitte.ca

www.deloitte.ca

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