Maintaining the Corporate Governance mindset in a distressed corporate situation

Andrew Tarbuck - Partner, Head of Capital Markets - Capital Markets / Turnaround, Restructuring & Insolvency

a.tarbuck@tamimi.com - Dubai Maze Tower

Introduction

Robust and enforced corporate governance has a key role in the success of both private and public companies in good financial health but becomes vital when there are signs of corporate distress or there is a deteriorating business environment. A loosening or even a breakdown of corporate governance within an organisation is a red flag signalling that there are fundamental issues that could jeopardise the long term future of the business, alongside more common flags such as liquidity, cash flow and operational issues. Affirming corporate governance should be one of the first elements to be addressed by a company’s board of directors (‘Board’) and senior management in a restructuring or insolvency scenario.

What is corporate governance?

Corporate governance is the collection of rules, practices, mechanisms and processes by which corporate entities are operated, directed and controlled. Good corporate governance should create a balance between the interests of an entity’s shareholders, its senior management, its other stakeholders and the wider community.

Good corporate governance should promote the rule of law, transparency, responsiveness, inclusion, efficiency, equality, accountability and participation and should be executed through a cultural mindset rather than treated as a tick-box compliance exercise. Corporate governance best practices for public companies can assist in building and maintaining investor confidence and can mitigate the risks of corruption and mismanagement, all of which can enhance the reputation of a public company, and potentially improve its share price. Corporate governance is also relevant for private companies although there are generally fewer mandatory requirements to comply with and there are no requirements for public disclosure of corporate governance or ongoing business and operational matters.

Corporate governance should not interfere in the day-to-day activities of a company; instead, it should set out the framework for the different roles and responsibilities of the stakeholders in the company such as its shareholders, board members, committee members, senior management, and auditors. It is when this framework starts to breakdown or be circumvented in times of distress that the Board, senior management and stakeholders should react to shore up corporate governance and, in many cases, enforce greater governance. A common signal is when a dominant Board member or a member of senior management exceeds the limits of their authority (possibly outside the bounds of a corporate governance authority matrix) by taking unilateral decisions without recourse to the Board or other senior managers.

When corporate governance breaks down

The alleged or actual breakdown in corporate governance has been at the heart of some of the most high profile distressed situations in the Gulf region, including recently Abraaj and NMC Healthcare which are good examples that show corporate governance best practice is vital for both private and public companies. Public companies have heightened mandatory corporate governance requirements that they must comply with, depending on the exchange upon which they are listed and the jurisdiction in which they are incorporated, and these are enforced to varying degrees by the relevant financial services regulator or the market itself through activist shareholders (such as Muddy Waters, Karl Icahn) and investor protection committees (such as the Association of British Insurers or the Pensions and Lifetime Savings Association in the United Kingdom). Private companies generally have minimum corporate governance requirements usually derived from the companies law under which they are incorporated; high standards of corporate governance will therefore be more of an ethos or mindset as part of a voluntary corporate culture. The Board tends to be less formalised. Private companies are subject to much less public scrutiny from their stakeholders as they are not required, from a regulatory perspective, to make ongoing public disclosure of their business operations and fewer stakeholders are simply easier to deal with. As a result, abuse of corporate governance may be difficult to spot until it is possibly too late and a turnaround becomes difficult or impossible due to insolvency.

Build the Board; thinking and acting differently

Adapting to a deteriorating or changing business environment is a challenge for any business and so the Board, senior management and investors need to work even more closely together instead of working in silos to protect what may be different short term interests. It is important to remember that they should be working in harmony to drive shareholder value and that, in the case of Board members, they will be under fiduciary duties to act in the best interests of the shareholders and, in the case of senior management, they may be under contractual duties to the company.

In a distressed situation it is extremely important to build and empower a proactive Board bearing the following in mind:

Oversight: ensure that there is keen oversight of, and active feedback to, the senior management of the company. In a public company scenario, this responsibility would usually fall to the Chair and non-executive directors, particularly those that are independent.

Communication is key: ensure that all stakeholders (principally through the investor relations function in a public company scenario), senior management and Board members receive timely and accurate information relating to the business. Financial and internal reporting procedures should be enhanced and thought given to additional key performance indicators.

Affirm corporate governance: ensure that Board and committee meetings take place regularly and, if in response to a particular business crisis (for example, COVID-19), establish a crisis committee. Authority matrices should be affirmed and all board members should be reminded of their fiduciary duties. Board members should remain relevant and active and thought should be given to shuffling or expanding the Board to bring in new and relevant expertise. Board members should ensure that they speak up, remembering that it is their role to maintain checks and balances against senior management.

Conclusion

At all times, a company should adhere to the minimum corporate governance practices that are relevant to it through applicable law and regulation and aim for best practice as a part of its corporate mindset and culture. In deteriorating or challenging operating conditions, affirming those corporate governance practices becomes key to a successful turnaround situation and hopefully staving off insolvency. Boards need to think and act differently to ensure that fiduciary duties are complied with to help chart a sustainable path forward.

For further information, please contact Andrew Tarbuck (a.tarbuck@tamimi.com).