

NAVIGATING THROUGH CRISES

A Handbook for Boards

Board oversight
Risk management
Crisis response
Strategy
Sustainable



NAVIGATING THROUGH CRISES

A handbook for boards



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Foreword

The global financial crisis of 2008 demonstrated that road to success for companies is fraught with unpredictable obstacles. It also illustrated the crucial importance of corporate governance and a strong board of directors to help companies manage the impact of unexpected crises.

Good corporate governance makes companies more resilient to unforeseen changes in their operating environment. A board of directors can accomplish this by setting a business strategy that considers potential risks, establishing appropriate risk-management and oversight systems, and institutionalizing decision-making processes.

Despite such precautions, some crises are unavoidable. When a crisis hits, good corporate governance can allow companies to effectively plan a response, distribute clearly defined roles and responsibilities, and set an effective communication strategy. Such actions help companies quickly recover and minimize the damage to their business.

IFC's corporate governance work cuts across both Investment Services and Advisory Services. In our investment operations, IFC looks at our clients' corporate governance risks and seeks opportunities to add value. In Advisory Services, IFC's corporate governance projects support improvements of policies and practices by companies, legal and regulatory frameworks, educational institutions, media, and civil society. Our work has led to greater investment in companies with better governance and a broader understanding of the benefits of good governance in the context of their markets. There is a clear link between better corporate governance and financial performance. This is smart investing.

This handbook presents crisis response from the perspective of boards and nonexecutive directors, with a focus on companies in emerging markets. It seeks to serve as a tool to help emerging market companies and their boards improve their crisis preparedness, recover from the recent financial turmoil, and emerge as more sustainable and competitive businesses. It is IFC's hope that these improvements will also make companies more resilient to the impacts of any future crisis.



Rachel Kyte
Vice President for Business Advisory Services

About the International Finance Corporation (IFC)

The International Finance Corporation (IFC) is part of the World Bank Group and was established in 1956 to encourage private-sector-led growth in developing countries. IFC fosters sustainable economic growth in developing countries by financing private-sector investment, mobilizing capital in international financial markets, and providing advisory services to businesses and governments. IFC helps companies and financial institutions in emerging markets create jobs, generate tax revenues, improve corporate governance and environmental performance, and contribute to their local communities.

The Board's Oversight of Crisis Management Project

IFC's Corporate Governance Unit has been set up to, among other things, support evaluations of corporate governance risks and opportunities for investment transactions and to design, implement, and support advisory services interventions that promote good corporate governance around the world. As part of its advisory services, and IFC's general response to the global financial crisis of 2008, the Board's Oversight of Crisis Management Project has been implemented with the support of the Oesterreichische Entwicklungsbank (OeEB), the Development Bank of Austria, since July 2009 with the objective of disseminating knowledge about best practices in responding to crises for boards of directors in emerging-market companies.

About the Handbook

Navigating through Crises: A Handbook for Boards (hereinafter, the Handbook) has been prepared as part of IFC's overall crisis-response program. The contents of the Handbook are based on empirical academic research and on the authors' own practical experiences. Additionally, information about emerging-market companies' actual crisis-management practices was drawn from training workshops held in more than 10 countries in Eastern Europe, the Middle East and North Africa, Central Asia, and East Asia. Conceptually, the Handbook uses a contingency approach (see Steger and Amman 2008), looking at various specific situations and their influencing factors and relevant decision-making criteria. Hence, it provides many practical ideas and tips for crisis management and the involvement of the board in a concise and easy-to-understand format for the greater benefit of the reader.

Who the Handbook is for

This Handbook is dedicated to board members, especially non-executive, independent board members, in emerging economies. It aims to support them in their work in corporate crisis situations—from the prevention of potential negative events to successful management when things do go wrong.

The Handbook does not distinguish between types of crises—internal or external, financial or other. While the global financial crisis of 2008 was the instigator for this project, the Handbook is general enough to provide advice for and solutions to other crisis situations.

The book applies to both public and private businesses and does not focus on any particular legislative framework of companies or countries, but rather on what should be done in a crisis, and how, from a board perspective. However, it is assumed that the size of the company allows for at least a minimal formal structure and a board of approximately five people, including outsiders.

How to use the Handbook

The purpose of the Handbook is to provide guidance and advice to boards and their non-executive directors on actions to take or consider relating to crisis management. It addresses two modes of operation:

1. A company is in crisis ("troubleshooting mode") and the board needs to act to prevent further complications and steer the company through rough waters to at least relative safety.
2. A company is operating in standard conditions ("maintenance mode"), but the board needs to ensure that it is prepared to weather any problems so that they do not escalate into full-blown crises.

The text is written in simple language and aims to be brief and practical. The analogy of driving a car is used in each chapter as a metaphor from everyday life that parallels the troubleshooting and maintenance scenarios that board members face.

Depending on your company's current situation, you may choose to focus only on sections relevant to that situation or to familiarize yourself with the contents of the entire Handbook. It is strongly recommended that all members of a board in a crisis or crisis-preventing exercise read this book together so that they have a shared understanding and can come together more quickly in deciding on specific actions. As a tool for applying the Handbook's guidance, chapters 2, 3, and 4 end with short case studies that can be used by board members to practice the lessons of these chapters, individually or in short group discussions.

The content of the Handbook

To help the orientation of the reader, below are brief descriptions of the Handbook's main chapters:



The first chapter presents an overview of how corporate crises and corporate governance are related. This summary takes special notice of the corporate governance settings that board directors find in emerging economies, reflecting the target audience of the Handbook. The chapter also provides an outlook on the financial crisis of 2008.



The second chapter focuses on preventing potential crises and deals with "maintenance mode." It discusses why and how good corporate governance, risk management, and the fundamentals of crisis management can help companies to circumvent crises, in the best case, and at least navigate through crises better than their peers. It starts by explaining the myriad possible crises board directors have to watch out for and then examines why board directors fail to see early warning signs of trouble. Finally, the chapter introduces a tool for better risk management from the board's perspective that should help in setting the right strategy for the whole company.



The third chapter is dedicated to “troubleshooting mode” and deals with the company’s efforts to manage an existing or apparent crisis. It starts by discussing several measures that can be taken to contain the crisis and exploring the board’s responsibility to add value. Next, it looks at the role of the board relative to the capabilities of management and different types of crises, using a typology of specific (“bullet”) crises and broad (“bomb”) crises. The following sections consider the changing roles of key personnel in crisis situations, specifically the chairman, the non-executive directors, the corporate secretary, the shareholders, and the crisis-response team. The chapter next examines what needs to be done if the board is not functioning in a crisis and then concludes by emphasizing the importance of clear and controlled communication.



The fourth chapter outlines a post-crisis review from the board’s perspective. In particular, it deals with the question of how to build and sustain a competitive company in the aftermath of a crisis. It also looks at how board work should evolve after the crisis—rather than resuming patterns that were the modus operandi before the crisis.

The Handbook concludes with practical appendixes that include a glossary of relevant terms and a bibliography of the references cited throughout the text as well as additional useful literature on the topic.

Acknowledgments

Thanks are due first and foremost to the authors of the Handbook, Ulrich Steger and Christoph Nedopil.

Their work was supplemented by contributions from many people. On the academic side we gratefully acknowledge the permission granted by two IMD colleagues to draw on their findings: Paul Strebel's work on the power structure of the board and George Kohlireser's work on psychological team dynamics under stress and duress.

In addition, we are deeply grateful to the IFC staff at headquarters and in the country offices who prepared 14 seminars in 12 countries and discussed with us in depth the conceptual framework of the Handbook and its adjustment to local conditions. We particularly want to mention Kakhaber Kutchava, Vladislava Ryabota, and Maya Polishchuk.

We thank the Global Corporate Governance Forum for its input and the participants in the Paris consultation (which included practitioners and experts from about 10 countries coming from different regions where Board Crisis workshops were held as well as representatives from OECD) who supplied invaluable comments based on their relevant experience and research.

This Handbook has also profited tremendously from the real-life experiences of all the CEOs, chairmen, executive and non-executive board members, as well as senior managers and some government representatives—altogether, over 330 people from more than 10 countries in Eastern Europe, the Middle East, and Central and East Asia—who participated in the crisis workshops and who openly shared their expertise on board work under crisis conditions. We hope that the shared learning in the seminars will play a supportive role in the further development of participants' board work, whether or not their companies' boards will have to address crisis conditions again. We promised confidentiality to all participants in our discussions, and we thank here the contributors whose arguments and quotations we have used anonymously throughout the text.

Finally, we acknowledge that this publication and the activities that led to its production would not have been possible without the financial support of the Oesterreichische Entwicklungsbank (OeEB), the Development Bank of Austria.



Davit Karapetyan, IFC Corporate Governance Unit

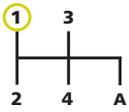
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Chapter 1

Introduction: Emerging Economies
and Emerging Crises



Bumpy Roads—Painful for Some, Fun for Others

For every occasion and road there is the right car. If you want to race along the highway, you get a nice sports car; if you want to explore the countryside, you get an off-roader; if you want to transport a lot of people, you get a van; and if you want to impress, you get a convertible. Not every car is made for every road: if you are racing along a bumpy road with your sports car you might be in not only for a rough ride but also for some expensive repairs to your front spoiler. Similarly, if it's raining, your convertible will be useless. However, even worse than the wrong car is a car that is not working properly or otherwise failing to serve its intended purpose. Such failures can have a variety of causes, from petty things such as dents (which make a convertible much less impressive) or flat tires, to more dramatic problems, such as a broken engine or malfunctioning brakes or steering, that make running the car uneconomical at best and downright life-threatening for passengers and passersby at worst.

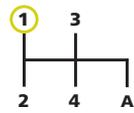
Corporations behave similarly to cars: some companies are simply better suited to certain business cycles and industries. Always being in the right spot at the right time with the right strategy and people is simply not possible. Thus, most companies will face a crisis sooner or later. The question is therefore not whether a crisis will happen, but how it will be dealt with. Not being prepared by examining the road ahead and performing routine maintenance can lead to a crisis with severe consequences for the company, its employees, as well as the wider environment!

This chapter starts by looking into the crystal ball: how much longer will the global economic crisis last? The chapter continues by giving an overview of how corporate crises and corporate governance are related. Special attention is paid to the corporate governance settings board directors find in emerging economies.

1.1.

IS THE GLOBAL FINANCIAL CRISIS OVER? A LOOK INTO THE "CRYSTAL BALL"

The financial crisis that arose from the subprime mortgage bubble in the United States led to the deepest global recession since the end of World War II. Arguably, its precise starting point was in the third quarter of 2007; remember the shockwaves that the rogue trading by Jérôme Kerviel of the French bank Société Générale sent through the world's stock markets at the end of June of that year. The bankruptcy of the American investment bank Lehman Brothers in



September 2008 was only the tipping point, when even the most optimistic had to admit that the “great moderation” was merely a great illusion. But it was not the first and definitely will not be the last of such crises.

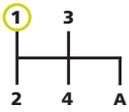
In any case, this crisis highlighted the interdependence of economies throughout the world, regardless of their stage of development. While a huge, more or less coordinated effort by governments throughout the world avoided the worst-case scenario of a long depression with spiraling protectionism (“beggar my neighbor” policies) and deflation, the way forward is more than uncertain. In complex systems—like the world economy today—nobody can really predict the results of specific actions. But for the coming years, three key characteristics will influence companies’ destinies:¹

- Uncertainty and ambiguity: There is no consensus or even a dominant trend (e.g., free trade and protectionism; state involvement and liberalism) that can be followed. Rather, we might see contradicting developments appear at the same time (e.g., inflation with sluggish demand; low interest rates and low investments) or at different times in different regions.
- Volatility: The business cycle or specific industries’ cycles might become more volatile, driven by dramatic changes in currencies or important raw materials or by political crises that spill over into the business world. This will accelerate the need to adjust to new circumstances even more rapidly—and with no stabilizing trend in sight to anchor expectations and perspectives.
- Regulatory and political interventions might become more frequent and impact not only one specific country, but the supply chains, trade relations, and business model of a globally operating industry.

Therefore, the most sensitive assumption is that in the years to come, more crises will likely happen, on the macro level, on the industry level, and—as a result—on the company level as well.

That assumption makes this Handbook even more pertinent for those who think that the financial crisis of 2008 is over. After all, the period after the last crisis is always also the period before the next one.

1 For more information on the topic of scenarios for a global outlook, visit the World Bank’s Web site (www.worldbank.org), the International Institute for Management Development’s “Research and Knowledge” Web page (www.imd.ch/research/challenges), as well as a number of other Web sites from, e.g., investment banks, consultancies, and the financial media.



1.2.

CORPORATE GOVERNANCE AND CORPORATE CRISES

Any crisis is a litmus test for the corporate governance system of a company, regardless of the legal framework, ownership structure, or industry. In a crisis situation weaknesses and frictions throughout the board, top management, and the company in general are more vividly exposed, and the ill prepared are brutally punished. And since the board is at the helm of the company, where key decisions are made, the rest of the organization shouldn't be expected to perform properly in a crisis if the board is malfunctioning.

Given the many types of corporate governance systems and of crises, it is important to avoid either arguing for a "one-size-fits-all" framework for boards and crisis management or, on the other hand, becoming overwhelmed by the constellation of potential frameworks. We hope to avoid these dilemmas as we will focus on

- boards in emerging and developing countries,
- strategic actions of the company and board and key management processes, and
- board-level interventions (as opposed to those at the management level, which are discussed in various other books; see Hopgood and Tankersley 2005; Mitroff 2003; Winter and Steger 1998) and especially the role of non-executive directors.

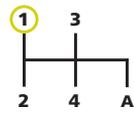
1.3.

CORPORATE GOVERNANCE AND BOARDS OF DIRECTORS IN EMERGING ECONOMIES

Corporate governance is important and relevant to companies all around the world, regardless of country, industry, firm size, or ownership. Many board practices in emerging economies are not reaching the full value-adding potential of good corporate governance. However, since there is no universal corporate governance model, corporate governance must be practiced differently for every company for it to be more than a valueless "box-ticking" exercise.

The corporate governance principles of transparency, accountability, and independent supervision of management performance should be tailored to specific companies' needs, depending on their ownership, core business model, and strategy; the requirements of capital markets, lenders, and regulators; and also cultural influences.

But the main driver of actual change will probably be the recognition by stakeholders that good corporate governance is an indispensable part of good management and effective leadership—the key ingredients for sustainable organizational success. So shareholders as well as boards need to review the effectiveness of their corporate governance system (see also chapter 4) and start a continuous improvement process.



1.3.1. The role of corporate governance

Corporate governance can mean a lot of different things. One useful definition is that corporate governance establishes clear structures of accountability, responsibility, and transparency at the helm of the company and defines the role of boards as well as management.

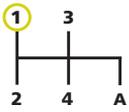
This means that with good corporate governance proper checks and balances between management and owners (and possibly other stakeholders, such as employees) are established, information flows and reporting are clear and transparent, accountability has been built between the different layers of the organization, internal controls and risk-management practices are set up, and high ethical standards are the norm throughout the company. With regard to crisis management, good corporate governance allows the board and senior management to capture arising problems and prevent them from becoming a crisis or disaster. And if a problem arises despite good corporate governance (e.g., from external factors), the roles and responsibilities of the different decision makers are clear, corporate bodies and officers know what to do, contingencies are discussed openly, and solutions can be found quickly.

1.3.2. Shaping factors of corporate governance

Often corporate governance systems are distinguished between two-tier and one-tier board systems. In legal terms, this differentiation can be important, but for the practical working of the board, it is insignificant. What does matter, as found in previous research (see Steger and Amman 2008), are the following four factors that shape corporate governance systems all over the world:

- Personalities—for example, the founder or long-time and successful CEO and his experiences, values, and leadership style
- Ownership—for example, family business or concentrated vs. fragmented shareholding structures
- Core business model—shaped by the industry as well as the company's lifetime, global exposure, and competitive focus
- Legal and cultural framework

In developing countries even many large and midsize companies are still run by the founding entrepreneur or family. Also, many publicly owned companies in emerging economies often have one large controlling shareholder (e.g., the state). These are just two factors that make corporate governance in emerging economies different from that in developed economies.



Thus, this Handbook does not differentiate between two-tier and one-tier boards. More relevant than that distinction are the differences between outsiders and insiders as well as executives and non-executives on the board.

Insiders are those who have a connection to the company—for example, through current or previous management positions, substantial investment, or kinship. Outsiders are those who have no direct link to the company other than their board directorship.

The difference between non-executive and executive directors is that the latter serve in a management position in the same company as well, while the former do not (though they may have management jobs in other companies).

The independent director has many definitions (something the lawyers dwell on for obvious reasons). However, to put it simply: an independent director is a non-executive director, mostly an outsider, whose main characteristic is his ability to make unimpaired decisions in the interest of the company.

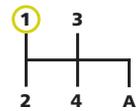
The relevance of these distinctions comes from information asymmetries that emerge through different directors' roles and links with the company, which often result in communication difficulties, politicking, and lack of transparency. And from the above definitions it is clear that corporate governance (which in large part is about creating a system of checks and balances for top management) cannot work if insiders and executives control the board, since they might have a vested interest in a system with few checks and little balance.

However, whatever their differences might be, board members work together for one organization and have to add value to this organization through their activities. And this is certainly never more true than in a crisis situation!

1.3.3. Board directors in emerging economies

The target group for this Handbook is predominantly non-executive directors in large and midsize companies in developing countries. They are especially in need of frameworks and guidelines that help them to make sense of often unstructured, hectic, contradictory, and even threatening dynamics. Interaction with many companies and their boards shows that the role of independent, non-executive directors is not well developed yet in most emerging economies, especially in those transitional economies that were the focus of this project. However, corporate governance in these countries will further develop, and accordingly independent directors will become more common on boards, for the following four reasons:

- The generation that founded most of the companies after the collapse of the Soviet Union is about to retire and thus should be removing itself gradually from daily business. The successor generation will in many cases not assume the same degree of concentrated power (e.g., because the founder has joined the board on the non-executive side—despite



some difficulties with such a set-up), and especially in fast-growing companies it will install more professional organizational structures and processes, starting at the board level.

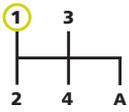
- The focus of emerging-economy companies on domestic markets or their dependence on a few international customers will change: while a small market decreases the complexity of management boards, it also limits revenues. Thus, many companies in emerging economies have started or are in the process of expanding their businesses internationally, making them more complex and more vulnerable to crises. The preparation for and supervision of this internationalization must be driven by a professional board (not least for the sake of attracting the necessary international investors).
- The deeper integration of these countries into the European and global economies will not only increase competition and thus make more modern systems (including corporate governance) necessary, but it will also transfer more best practices and experiences of corporate governance into these countries. For example, foreign (as well as domestic) investors and lenders will require more transparency through independent directors in the years to come (see Nedopil 2009).
- The implementation of corporate governance frameworks takes time. Legislation that closely follows international standards is now in place in most countries. But the legal system is often cumbersome, weakly enforced, or even marred by political and corrupt influences. This makes board work often difficult, especially for companies that strive for transparency and for stakeholders who aim for accountability. The development and true implementation of the necessary institutional infrastructure and “soft” behavioral rules to handle issues such as corporate social responsibility, conduct with employees, as well as the behaviors of the different board directors will take at least five and probably 10 years (soft behavioral rules are partly described in the many codes of conduct that are increasingly written for countries, industries, and companies). One should remember, too, that in developed countries, the concept of corporate governance with much more proactive boards only gained prominence in the mid-nineties and then was accelerated by the “dot-com” crisis and the aftermath of corporate crises such as that of Enron in early 2000.

Therefore, in all situations—company specific and country specific—the key question is, Does the corporate governance system add value to the organization?

Ask

1.3.4. Does the board add value?

This question can certainly only be answered on a case-by-case basis. It requires a close look at the specific characteristics of the structures and processes of corporate governance according to the four shaping factors described above. It can also be answered by examining the following four factors:



- Does the board add unique input to the development and implementation of strategy and contribute new ideas and knowledge of trends?
- Does the board provide a broad information base through a diversity of directors who test and probe assumptions in strategy implementation?
- Does the board enable early detection of negative developments and fast correction of mistakes through effective supervision?
- Does the board conduct a good selection process and provide intensive coaching in order to produce a high-performing top management team?

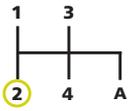
Lessons for the Road

There is not a single best corporate governance system, but in general transparency, accountability, and cooperation at the top of the organization add value. A crisis is the litmus test: Can the company make better decisions than its competitors?

It is the responsibility of board members to ensure that even in good times their corporate governance system is working properly, because it will be stretched severely during a crisis. So ask yourself, What have you done recently to improve the functioning of your corporate governance system and the effectiveness of the board?

Chapter 2

Preventing
Crises



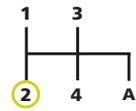
Car Maintenance

Speeding a car around tight corners or racing against another car can be great fun. But before you climb into the driver's seat, you should perform some essential safety checks: Are the brakes in working order? Are the tires still good? How is the engine running? Does the steering work properly? Do I have functioning seatbelts and airbags? Furthermore, you'll want to know the weather conditions so you can put on the right tires.

In order to race a car on a regular basis—and not have to change cars all the time (which would be very expensive)—you'll definitely want to check the vehicle's condition regularly to keep it running as fast and reliably as possible. And if your car doesn't work as it should, perhaps because of an accident or a breakdown, you'll need to know what's broken and fix it as quickly as possible in order to go at full throttle again—instead of falling behind your competition.

Similarly, if you want to speed ahead with your company and beat the competition, you need to perform some regular checks so as not to be slowed down by minor defects and also to be prepared for major breakdowns.

"I guess one of the reasons that my company managed the crisis relatively better than others is because we had a great leadership team and board, who listened to one another and were able to communicate throughout the organization. There were just no bad surprises due to a high level of transparency and openness." —Board director, Egypt



2.1.

IMPROVE YOUR CORPORATE GOVERNANCE TO PREPARE FOR CRISES

Crises have many causes, sometimes external, sometimes internal; some come suddenly, while others evolve over time; some affect whole economies and others only a specific company or even just one department or business unit.

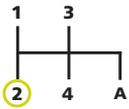
Good corporate governance (see chapter 1) may be of great value to any organization's ability to prevent negative events from affecting the company or escalating to a crisis or disaster level. It would be hubris to claim that good corporate governance can prevent all corporate crises. But a good board of directors can at least help a company minimize its risk by doing the following:

- Setting the right strategy with an appropriate risk appetite for the company (e.g., an investment bank has a very different risk appetite than a retail bank)
- Overseeing the implementation and execution of risk-management systems
- Scanning the environment and understanding the drivers of business in order to help detect and comprehend crises earlier
- Ensuring better preparedness and more robust response to crises (e.g., through the creation and testing of crisis-response plans)
- Demonstrating leadership in thinking through better decisions and avoiding panic
- Eliminating certain reasons for internal crisis (e.g., by having a CEO succession plan in place in case of a sudden departure)
- Giving external stakeholders, especially investors and employees, confidence in the future of the company

Act

To illustrate this last point briefly, a recent IFC study in Latin America (IFC 2009) indicates that companies with good corporate governance experienced a lower loss on their stock price during the financial crisis of 2008, based, for example, on better return on equity and other key performance indicators, relative to their less well-governed competitors. This is an example where corporate governance delivered measurable value to companies and their stakeholders.

The reasons for better corporate performance are pretty simple: good corporate governance leads to better, more robust decisions. There are three drivers of this connection:



- Team decisions are on average better than individual decisions, simply because they are based on a broader set of information.
- A rational process—especially in conditions of uncertainty (and most strategic decisions of boards are made in such conditions!)—allows a better test of assumptions and facts and clarification of the goals, dilemmas, and risks involved than spontaneous, intuitive decisions (which may be fine for routine operations but are not ideal for setting strategy).
- Independent directors have a different perspective than insiders. They enrich the information base during board meetings through their experience in other industries and organizations, and they are more likely to discover emerging trends and recognize patterns (in other words, to see “the big picture”). When truly independent, they can speak out about problems early and not hesitate for “political” reasons.

For shareholders, however, who are supposed to elect board directors, in both emerging and developed economies, a difficulty lies in finding qualified board members who can be trusted and bring value to the company. This difficulty is often more pronounced in developing countries, for two reasons. First, there are simply fewer experienced managers who are available to take such a time-consuming job. And second, finding non-executive or independent board members who can be trusted seems to still be a problem. Although institutes of directors and other similar organizations have sprung up in many emerging economies, there is still a long way to go to make the system really work.

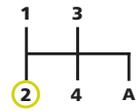
Another problem that can be found in some emerging economies has to do with executive institutions. Whereas laws are often in place to regulate the roles of shareholders, boards of directors, management, and employees, the implementation of these laws remains patchy. To give one example, there is no country that legally allows bribery, yet it is still commonplace in too many countries, developed and developing alike. At the same time, laws and their implementation seem to be changing with time (which can be good or bad) and between companies, meaning that some companies, thanks to their political connections, get preferred treatment, while others might be punished for supporting the “wrong” politician (which is definitely bad). Nevertheless, boards and managers need to (and can) help their companies survive crises even within such settings.

2.2.

UNDERSTAND CRISES TO MANAGE THEM

2.2.1. Typical corporate crises

Companies operating under market conditions are inherently exposed to different risks, here defined as negative deviations from a plan. A crisis is a negative deviation that is severe and can threaten the very existence of a company.

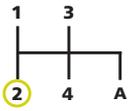


Analyze

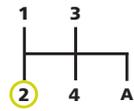
Crises can show up in many forms and can have many causes. The following typology clusters some key characteristics and thereby may help board members to understand and analyze crises in order to find solutions that fit any particular situation. Note, first, that a crisis can (and usually does) contain elements of more than one of the clusters described in the following table. Second, it is important to always remember that a conflict—for example, between board directors—is not necessarily a crisis if it is dealt with properly. Disagreements should be welcomed, as long as they are constructive. If a conflict is not dealt with properly, though, it can develop into a serious crisis with severe consequences, such as the loss of key personnel.

TABLE 1. Typology of Crises

Category	Type of crisis	Features of crisis	Example
Time frame	Sudden	A sudden crisis often comes unexpectedly (which does not mean the company should not be prepared).	Accident (e.g., the sinking of BP's Deepwater Horizon platform in 2010), natural catastrophe
	Evolving	An evolving crisis grows over time (like a bubble).	Financial crisis, housing bubble, adding up of firm mistakes (e.g., the Asian crisis of 1997; Boeing's Dreamliner problems until 2010)
Source	Internal	The source of an internal crisis is within the company.	Key personnel leave; employees commit fraud (e.g., Jérôme Kerviel's rogue trading at Société General in 2007; Satyam Computer Services' accounting fraud in 2009)
	External	The source of an external crisis is outside the boundaries of the organization.	A key supplier defaults (e.g., the energy shortages in Ukraine after problems with Russian gas supplies in 2008), investors withdraw their support
Company personnel	Leadership	Leadership crises happen at the top of the company (meaning that the company can mostly continue with operations).	Sudden departure of CEO (e.g., Fritz Henderson's resignation from General Motors in 2009)
	Operations	Operational crises affect the production processes of the company, with consequences such as missing revenues and malus payments.	Factories are shut down due to lack of supplies or strikes (e.g., Toyota China's shutdown due to strikes in 2010)



Category	Type of crisis	Features of crisis	Example
Related parties	Shareholder	In shareholder crises, investors flee the company (making new and necessary investments difficult).	Investors sell off their stock (e.g., BP's market capitalization dropped by 1/3 after its oil spill in the Gulf of Mexico in 2010)
	Stakeholder	A stakeholder crisis involves, e.g., society at large, employees, or interest groups.	Regulators get involved in the business; nongovernmental organizations (NGOs) accuse the company of wrongdoing (e.g., Greenpeace's campaign against the disposal of Shell's Brent Spar platform in 1995)
Character	Psychological	Some crises are completely psychologically driven and have no grounding in the real business situation.	Rumors or accusations lead to extra diligence by regulators or investors (e.g., rumors of an iPhone 4 recall by Apple made the share price drop in 2010)
	Factual	Factual crises have a grounding in actual operations or leadership.	Actual problems with payments or operations (e.g., the decline of tourism after political demonstrations in Thailand in 2010)
Driving forces	Political/regulatory	In political/regulatory crises a company has lost the trust of the regulator or government (and might lose its license to operate).	Extra layers of regulation changing the business or political scrutiny (e.g., state-imposed embargos, like those on Iran; state intervention in airline markets)
	Market	A market-driven crisis has to do with competition and demand from customers.	Customers lose interest in the company's products due to problems with quality (e.g., mySpace's decline in usage because of better quality at other social networks)
Impact	Financial	In a financial crisis the company has trouble securing the necessary cash to pay its bills.	Problems with refinancing; lack of liquidity (e.g., Porsche's financial miscalculation in its attempted takeover of Volkswagen in 2009)
	Material	A material crisis has effects on the value-creation process of the company.	A system or a product is outlawed and hence the company might lose its license to operate (e.g., the uncertainty around Google China's extension of its operating license in 2009/10)



2.2.2. Typical corporate governance crises

In fact, many of the corporate crises discussed above have their source in the (lack of) corporate governance of the company. There are four common types of conflicts at the helm of the company that create corporate governance–related crises:

- Shareholders vs. shareholders: for example, when majority shareholders make decisions that are good for the short-term profits of some majority investors, but not for the long-term interest of the company and of its minority (and often less active) shareholders
- Shareholders vs. management: for example, when shareholders would like to see higher dividend payouts while managers plan to invest more
- Board vs. management: for example, when the board has lost confidence in management, but is unable to replace it (perhaps because of a lack of succession planning)
- Board members vs. board members: for example, when there is personal acrimony, different interests, or hidden agendas (normally because of a lack of leadership by the chairman of the board to suppress such behaviors) that lead to a dysfunctional board, unable to make decisions

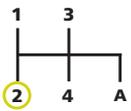
Most crises of the corporate governance system are caused by conflicts of these types that are not managed well. As mentioned above, conflicts are not inherently bad (often quite the opposite), but they need to be dealt with in a constructive manner. If conflicts get out of control they make a great source for crises.

Shareholders can play a key role in the management of conflicts by monitoring the effectiveness of the board (especially if they are a small group). They also need to intervene if they see that decisions are not getting made or that the board is not living up to its responsibility.

However, remember that essentially unforeseeable factors such as fraud, personal issues (e.g., a senior manager's sudden decision to retire), sickness, and death can create crises at the helm of the company as well. Whereas the sources of external crises cannot easily be controlled (though they can be managed), because their roots are beyond the reach of the company, most of the sources of internal crises can. Therefore, don't let a conflict escalate into a crisis, respond early to warning signals (e.g., lax implementation of safety standards), watch potential trouble spots carefully, and take the supervisory responsibilities of the board seriously.

Remember that if you think everything is going fine, you may just have no idea what is going on!

Advice

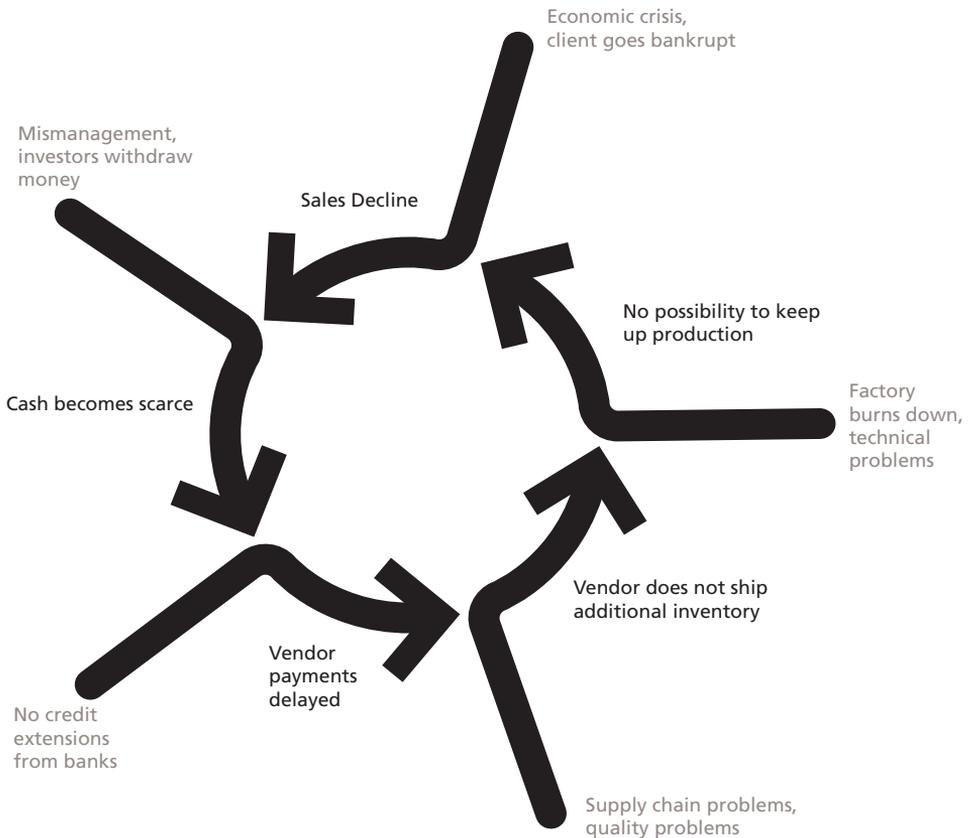


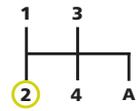
2.2.3. Vicious cycle of crises

Crises have one particularly unfortunate feature: they rarely come alone, as they soon spread to other areas from wherever they start. The types of crises named in Table 1 are not mutually exclusive, but usually come in mixtures. This makes the recognition of the true source of a crisis (which is important for solving the crisis sustainably) difficult, since a vicious cycle might start.

To give an example, Figure 1 shows the vicious cycle of a cash crisis. A company might slide into a crisis because of a decline in sales, perhaps due to wider economic factors. The decline in sales leads to a liquidity shortage, making payments to suppliers increasingly difficult. However, without inputs from suppliers the production of goods is interrupted, and therefore the possibility of selling to paying customers is cut off as well. As a consequence, sales decline further. This is just one possible iteration of the cycle; Figure 1 shows that there are many other possible entry points.

FIGURE 1: Vicious Cycle of a Cash Crisis





Analyze

Thus the real challenge is to find the true source of the crisis and to interrupt the vicious cycle and the contagious spread of problems—on the macro level as well as on the firm level, since once you are in a crisis, more crises will certainly come.

2.3.

UNDERSTAND WHY MANAGEABLE PROBLEMS EVOLVE INTO CRISES

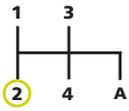
As mentioned above, most crises do not come like a “flash out of the blue.” Yes, there are blind spots, because managers and board directors simply cannot pay attention to every detail in a complex business environment. But usually there are early warning signals, even red flags, before an originally manageable problem evolves into a full-blown crisis. That is true of both internal and external crises. As an example related to internal crises, a breakdown of the information technology (IT) system with severe consequences for a company’s operations may be attributable to a lack of back-up capacity or to fraudulent negligence of IT security. Unfortunately common crises arising from the external environment include reckless investment by managers in massive capacity expansions at the peak of the business cycle or structuring of heavily debt-financed deals in the “gung-ho” phase of a financial bubble (of which there have been three in the last 12 years).

As you have surely observed yourself somewhere in your industry, neglecting early warning signs happens, and quite frequently. The reason is not so much a lack of individual intelligence (though that can be found as well, including a lack of understanding of the subject and the business), but instead typical barriers and biases in the decision-making process at the helm of a company that prevent or further complicate the process of finding appropriate solutions to crises.

It is key to confront ugly facts early on and deal with the mess, instead of hiding it in the closet. The hope that problems will go away if only they are ignored long enough goes against all empirical evidence—on the contrary, they tend to get worse if left unattended.

The following sections discuss three typical barriers to sound decision making:

- Corporate-political barriers
- Organizational barriers
- Psychological barriers

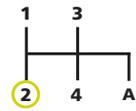


2.3.1. Corporate-political barriers

Corporate-political barriers to recognizing crises early are the most “macro” type of barriers. They include political influences on the corporate decision-making process, which impede rational thinking. Table 2 gives examples of corporate-political barriers and possible solutions to them.

TABLE 2: Corporate-Political Barriers

Corporate-political barrier	Possible solution
The majority shareholder, who may or may not have a board seat, dominates decision making and prevents other board members from openly discussing key issues, mainly because of cronyism (board members may not want to “bite the hand that feeds them”) and long-established friendships.	Every board member should have the opportunity to speak up—something that could be institutionalized: in every discussion each independent board director should ask one critical (useful) question. In general, every board member should know that his responsibility lies with the company, not the people.
One decision maker exerts improper influence by imposing his will on others without proper justification and reasoning (a typical pattern: the aging owner or founder is destroying what he has built up by his inability to “let go” of control when he should).	Such a situation takes a lot of time, patience, and skill to overcome. The board should be like a woodpecker—always on the same spot—and make the advantages of a proper board with divisions of power (e.g., that team decisions are on average better and more sustainable) clear to the power-hungry.
External non-business influences (e.g., some board members may make decisions that favor autocratic regimes or friends and family but not the company)	This barrier—typical in many developing countries and state-controlled industries—is the most difficult to deal with. Too much transparency (e.g., in the company’s earnings) might bring the treasury to the company’s door, asking for extra tax money. The best way to deal with such pressure is to avoid “murky waters” from the beginning and be very clear about the company’s contribution to the social welfare (e.g., jobs, taxes, reputation, investment) to fend off any demands.



Corporate-political barrier	Possible solution
Key decision makers' conflicts of interest	There is a good saying: "If you have a conflict of interest, you have no interest in conflict." There are two ways to handle conflicts of interest: if the conflict is material (i.e., permanent—because the board director is also working for the competition, e.g.), it must be permanently resolved (she must give up her board seat). If the conflict of interest is limited (i.e., for one decision—because a single transaction with the board director's cousin is discussed, e.g.), it can be avoided by a temporary abstention (the board director should not participate in the discussion). In any case, the chairman of the board needs to know about all conflicts of interest and take the appropriate measures.
A culture of hiding, turf wars, and political games instead of a high-performance culture built on merit	If such a culture has been dominant in the company, the only solution may be to radically change the culture by replacing key personnel who are responsible for the culture with more trusted and "modern" employees.

In summary, there is no easy solution to overcome corporate-political barriers, since changes need to be institutional (rather than, e.g., personal). Hence, both patience and the willingness to undergo radical reform must be present if these barriers are to be dealt with sustainably.

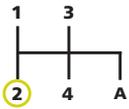
Advice

2.3.2. Organizational barriers

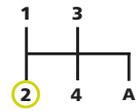
Organizational barriers are especially present in large or diversified companies because of these organizations' complexity and consequent lack of transparency. Since crisis situations can evolve from very small beginnings (e.g., the world's largest insurance company, AIG, was brought down by a niche business that generated approximately 1 percent of its turnover), it is important to be aware of the potential organizational barriers outlined in Table 3 and to work on overcoming them.

TABLE 3: Organizational Barriers

Organizational barrier	Possible solution
Interdependencies between functions or departments are ignored, and they operate as "silos."	Create transparency (e.g., by standardizing reporting), accountability (e.g., by setting clear responsibilities), better communication (e.g., by setting regular meetings or exchanging personnel between departments through secondment programs), and common understandings (e.g., of the strategy and risk appetite of the company).



Organizational barrier	Possible solution
<p>"Fragmentation biases" occur when those who make a decision do not experience its consequences (which often happens, e.g., in mergers and acquisitions [M&A])—situations where those who in the end will be running the new business are not involved in the negotiations).</p>	<p>The right incentives have to be set for each decision maker. Somebody who is only rewarded for short-term success will only try to achieve short-term success. Thus, a mixture of long-term, medium-term, and short-term incentives needs to be developed, depending on the company's strategy and the task of the employee (and remember, the supervisor should never have the same incentive metrics as the subordinate).</p>
<p>Short-term goals and incentives create a "moral hazard": employees make decisions that generate short-term success so that they can earn a bonus, with no regard for the long-term consequences.</p>	<p>As in the case of fragmentation bias, it is necessary to set the right mix of short-term, medium-term, and long-term incentives in order to overcome this bias.</p>
<p>Lack of accountability and clearly defined responsibilities allows unpleasant issues to "fall through the cracks."</p>	<p>Reporting and hierarchies have to be clear. Remember that those who have more than one boss may as well have no boss at all. An employee can be more effectively supervised and held accountable if she only has one manager.</p>
<p>Biased information or reporting systems, which ignore or underestimate risks or leading indicators</p>	<p>It is the board's own responsibility to get balanced reporting. If the board feels that reports are too biased, outside experts should be invited to share their views on specific topics.</p>
<p>Misunderstandings due to cultural differences, not only between nationalities, but also between professions (e.g., financiers vs. engineers, businessmen vs. lawyers) and generations (e.g., those who have grown up in the old system vs. those who have a modern, Westernized education). Especially under stressful conditions (when nerves are raw), employees may resort to stereotypes or simplifications based on prejudices when dealing with people from a different culture.</p>	<p>It is the chairman's responsibility to overcome this barrier in board meetings. He has to set the tone for open, frank, and respectful discussions and help correct possible misunderstandings. At the same time, each board member has to respect her peers and their cultural backgrounds.</p>
<p>Lack of supervision and response from the board or shareholders; in most cases, "the buck stops" at the board and ultimately at the shareholders. Legally, the board has the ultimate responsibility for setting goals, strategy, and organizational design and has an oversight duty of care and due diligence. If the board lets certain responsibilities slip (e.g., by failing to enforce safety standards), no one should wonder if those matters have a low priority at lower levels in the organization. It is thus shareholders' responsibility to elect the best board members and endow them with the necessary resources and powers to do their job properly.</p>	<p>In this case, a change of certain personnel (e.g., the chairman) might become necessary in order to shake things up. To avoid the need for such drastic measures, the board should be aware of its responsibilities and set action plans for how to live up to its role—something that could be done during a board retreat. A clear agenda (e.g., a board calendar—set during the board retreat) should help to concentrate on the right tasks and responsibilities.</p>



Advice

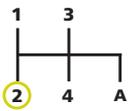
In summary, in order to overcome organizational barriers to recognizing red flags, it is important that the board establish sound structures and processes of accountability, assign clear responsibilities, and create a high level of transparency. Only then will it be possible to avoid blind spots. All members of the organization have their part to play in preventing, recognizing, and dealing with crises. However, they can only play that part if they know what it is.

2.3.3. Psychological barriers

The basic truth is that humans don't like discomforting news. There is an inherent tendency to look for good news (for oneself) and information that confirms one's worldview (e.g., to support decisions already taken). Everything else is easily overlooked, in hopes that the brutal negative facts will disappear (though they usually don't). Table 4 sums up the most relevant psychological barriers and possible solutions.

TABLE 4: Psychological Barriers

Psychological barrier	Possible solution
"Herd behavior" happens often since almost no one wants to make a mistake alone, so managers follow the masses. This problem is certainly exacerbated by consultant fashions and media hype.	Take a step back and ask whether you truly agree with a proposal or whether you just don't want to rock the boat. At the same time, though, pick your battles carefully—some are not worth fighting.
"Hindsight bias" happens when managers see events that have occurred as more predictable than they actually were before they took place.	On the one hand, documentation helps all parties to stay aware of past discussions and opinions. On the other hand, it remains the board's responsibility to make strategic decisions for the future of the company—decisions where personal experience helps but hindsight is not yet available.
"Consensus bias" happens when board members are reluctant to challenge the (often easily achieved) consensus and just follow management's suggestions. This can be attributed to the axiom that disagreeing requires more energy than agreeing.	As in overcoming herd behavior, it is important to pick your battles carefully, yet evaluate the consensus thoughtfully and be willing to challenge common opinion. Remember, you were asked to join the board not as a rubber-stamper but as someone with informed opinions.
"Escalation bias" can be observed when managers will not walk away from negotiations or reverse bad decisions because they regard this as defeat. As a result, bidding or the execution of decisions escalates and reversal becomes increasingly expensive (and embarrassing).	Taking a step back to see the bigger picture helps in this case: Why have we taken a decision in the first place, and what has changed since then? Do we need to adapt our strategy accordingly?



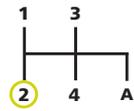
Psychological barrier	Possible solution
<p>"Attribution bias" can be seen when managers attribute successes internally (often to themselves) and failures to external forces. Another way of putting it: "Success has many parents; failure is an orphan."</p>	<p>Accountability is key: it must be clear who is responsible for certain decisions (or failures to decide). Thus, operational structures and reporting lines have to be established properly.</p>
<p>"Losing face" threatens the openness of discussion on the board, since in some cultures a direct affront is unacceptable.</p>	<p>Every culture has its ways of confronting people with unpleasant truths—some more blunt (like the Germans), some more indirect (like many Asian cultures). Hence, in order to speak up in the proper manner and thus to be heard accurately, it is important to understand the cultural context.</p>

One interesting (and dangerous) additional barrier to sound decision making on the board is overconfidence. In particular, successful organizations and their leaders easily become overconfident. A recent example is Toyota's rapid expansion, driven by overconfidence, and its subsequent massive product recall because of quality problems. Other examples include entrance into new markets or industries or acquisition of other companies without due diligence because a company feels strong enough to take on every new challenge.

Such mistaken feelings of invincibility in board members and other managers can be thought of as the Siegfried syndrome.² Key characteristics of the Siegfried syndrome are

- having a "me, me, me" attitude instead of putting the company first,
- no longer listening to others,
- changing accounting rules to "massage" numbers in order to present the appearance of success,
- frequently changing the top management team because of one's perceptions of others' incompetence or fear of competition,
- providing selective information to different board members in order to always have the best overview for oneself,
- showing early indications of paranoia and violent temper, and
- having no new ideas or initiatives, out of the belief that one's past performance is already a winning strategy.

² Siegfried is the main character of the mythological Nibelungen saga (also the basis of Richard Wagner's operatic *Ring Cycle*), who became almost invincible after bathing in dragon blood.



Advice

In summary, it can certainly be said that overcoming psychological barriers is not easy. One solution is to have a diversity of board directors, who can bring different perspectives and perceptions to the discussion. A precondition for such openness is that the board must have a culture that allows for challenging, criticizing, and questioning one another. Obviously, the chairman of the board has to set the tone and maintain a level of trust to ensure sustainable cooperation between the various parties at the helm of the company (e.g., by ensuring that everyone is allowed to speak up, no one gets offended, and the time allocations on the agenda reflect the business needs and priorities). On a personal level, it is important to take a step back and to think again for a few minutes about your decisions. This doesn't take long, but it definitely helps to solidify your opinions.

2.4.

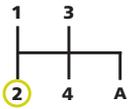
REDUCE THE PROBABILITY OF CRISES

“Why was our board surprised by the crisis? Pretty simple: we looked too much into the rearview mirror and not enough ahead.”—Independent board member, Caucasus region

It must be emphasized that even in a company with a board that has overcome all of the above barriers and makes unbiased decisions, those decisions can turn out to be wrong in the end, since they are unavoidably still made under conditions of uncertainty. Uncertainty is the very nature of strategic decisions made at the helm of a company in a market economy. Moves by competitors, technological dynamics, or changes in customer demand can render even the best-informed (based on information available at the time), least biased decision into the opposite of what was intended.

For the long-term survival of a company it is vital not to work under the assumption that everything will go according to plan, but to assume that there will be changes, new developments, and also mistakes. The board must design an organization that corrects mistakes and reacts to changes quickly. This requires a culture of openness and transparency that adjusts rapidly to the de facto results of a strategy and its execution and to the reality of the changing business environment.

Aside from the fact that a good corporate governance system inherently has some features that ensure sound decision making and risk management in general and thus reduce the probability of crises (see chapter 1.3.1), there are specific actions a board can take to minimize the occurrence or the consequences of crises, and these are examined in the following sections.



2.4.1. Look for early warning signs

As argued above, most crises evolve over time, and “the writing on the wall” can be seen if one wants to see it. Board members have a special duty of care here, and outsider board members have a special role to play: since they are not as deeply immersed in business operations as insiders, they can more easily see unusual patterns, emerging trends, the big picture—and can more neutrally assess the potential implications of many signs for the company.

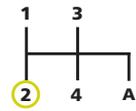
In order to see crises at their outset, the following early warning signals should be looked for:

Red Flags

- Psychological decision biases in top management (see chapter 2.3.3), especially overconfidence
- Changes in accounting rules or reporting that lead to more favorable numbers
- Cash flow that is not coming from operations, but from nonrecurring sources
- Costs, especially overhead, that grow faster than revenues
- Negative reports by financial analysts and negative reactions by investors to company results
- Even slight reluctance of creditors to provide further funding (financial analysts rarely have good suggestions, but often have good questions)
- High turnover of employees and management (also look for employee turnover in specific departments or subsidiaries)
- Unexpected moves by competitors (e.g., a divestment or specific investment)
- Public concerns that can lead to action by regulators
- Observable discontent among customers
- Bashing in the media (it can also help to monitor the so-called hate Web sites of disgruntled employees or customers)
- Unreasonably high M&A activity, including overpaying for assets

2.4.2. Use the available tools

Every company has a couple of processes to generate information about its operations and the business environment, and these often contain early warning signals of coming crises. This information should definitely be analyzed and used in strategic decision making:



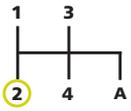
- Reports of external auditors: Audit reports, especially the so-called management letters in which external auditors voice their findings beyond just checking the numbers, can be very informative. The key is that the (supervisory) board is communicating directly with the external auditors and closely examining their findings—and that the nomination of external auditors is done by the board, not management, to ensure their independence and critical perspective.
- Reports of internal auditors and compliance reports: These can alert boards to dangerous operational patterns (not just isolated incidents) that could expose the company to considerable risks (e.g., systematic fraud in the form of an increasing gap between the book value and real value of stored goods).
- Reports on regulatory interventions: If a company has constant regulatory issues, some aspect of its implementation of systems might be awry (e.g., even before the blowout of its Deepwater Horizon platform BP was far above the industry average in penalties for violating safety standards).
- Reports on industry trends: Often industry trends (upward and downward) can be seen before they affect a particular company, and the necessary precautions can be taken to steer clear of overcapacities as well as undercapacities.

2.4.3. Conduct robust risk evaluations

One difficulty in understanding early warning signs is the way in which information is presented to the board. Often, information reaching the board level is fragmented and lacks transparency because it comes from multiple sources—be they different countries, different subsidiaries, different departments, or different people—each with their own agenda.

The fragmentation of information is especially difficult to grasp for non-executive and independent directors, who lack an internal view of the company and are prone to misunderstanding its interdependencies, especially internal relationships. Nevertheless, it is clearly the responsibility of the board as a whole (including non-executive and independent directors) to bring the evidence together and oversee all of the risk exposures of the company, prioritizing resources to deal with the risks and overseeing the system of implementation. Ultimately, neglecting key risks will lead the company to crisis. Risk management in times when there is no apparent crisis is sound risk management.

If this work is done properly, the board can help to significantly reduce the risk of crises, quicken the response time if a crisis hits, and also help the company to outperform the competition during and after a crisis by focusing the company's resources on the "right" risks to take. After all, doing business is all about taking calculated risks.

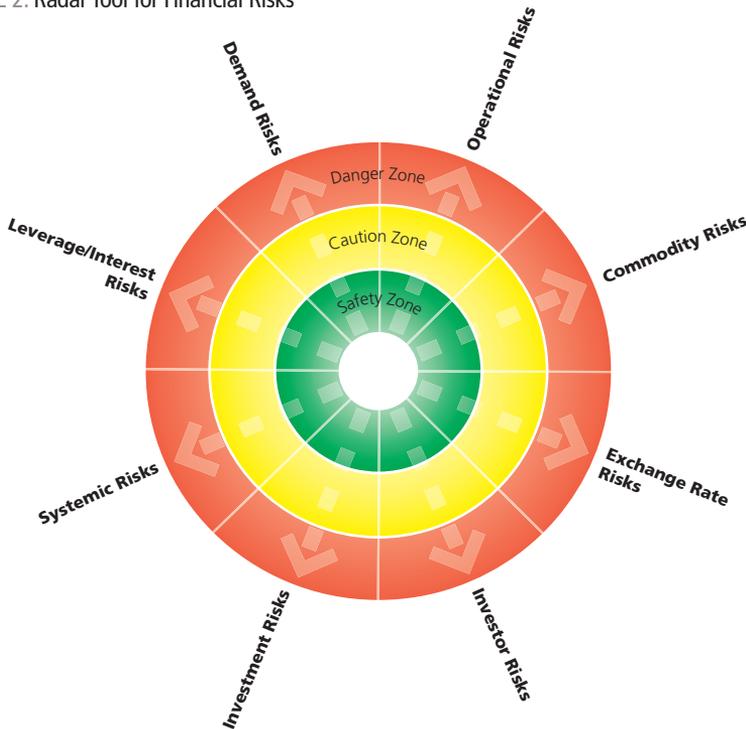


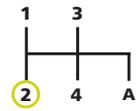
There are a number of tools available to board directors to evaluate the company's risks in order to minimize the chances for crises and failure during crises. These include, for example, McKinsey's Heat Map, scenario planning tools, risk-exposure calculators, and various numerical tools (see Buehler and Pritsch 2003; Simons 1999; Stulz 2009). However useful these tools are in their respective applications, there are certain drawbacks to their use by boards—especially with regard to their ability to systematically assess the overall risk exposure of the company and integrate all fragmented information.

Thus, this Handbook provides a newly developed “risk radar tool” for top management and boards. As found in the workshops conducted by the Board's Oversight of Crisis Management Project, the risk radar tool is an easy-to-use, systematic, and practical instrument for evaluating and visualizing the risk exposure of a company on various levels—a prerequisite for prioritizing risks and deciding on the appropriate risk-management strategies.

As an example, Figure 2 shows the Financial Radar. The risks in the radar are the most common and important ones that the board has to monitor in most companies. Appendix C shows additional radars for internal risks and external risks.

FIGURE 2: Radar Tool for Financial Risks





Analyze

In order to use the radar tool to analyze and evaluate a company's risks, it is important to first recognize and accept the mutual influences and interdependencies of the various risks with each other and with other factors.

For example, consider the commodity risk component of financial risk: the costs of commodities are affected by politics, exchange rates, and industry cycles, while at the same time they influence the price of produced goods and investor risks, among other things. This can be most easily seen in companies in the chemical or automotive industries, whose stock prices are often correlated with the price of crude oil. Tables for all categories of risks containing examples of their interdependencies can be found in Appendix C.

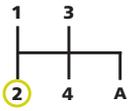
Once the risks and their interdependencies are truly understood, the risks can be evaluated according to

1. the likelihood that they will hit the company,
2. the severity if they hit (which depends on whether countermeasures are in place), and
3. the relevance to the company (i.e., the importance of the business that will be hit by the risk).

Using the terminology of Simons (1999), each risk can be given a grade from 1 to 3 as a result of the assessment. Grade 1 represents a company in the safety zone with respect to a particular risk. Companies in this zone are fairly safe from unexpected events or errors related to that risk and can even think about taking on additional risks. Grade 2 means that the company is in the caution zone, where companies that have a good risk-management system should not worry but should remain alert to any changes in the risk. Grade 3 shows that the company is in the danger zone, which means that there are immediate negative implications for the company and swift action is necessary.

There are two ways that companies can conduct risk assessments. The first is for managers or the board to invite internal as well as external experts to explain to them the risks the company is exposed to. Once the board directors have understood the risks inherent in the business, they should discuss among themselves and evaluate the risks accordingly. The second way is for every board director and possibly senior management members as well to do the risk evaluation individually. Once all involved parties have made their informed evaluation, the results should be compiled and discussed to find out how different people in the group are evaluating the company's risks and why. Important prerequisites for making this process work are that board directors take their responsibility seriously and inform themselves through corporate information sources (see chapter 3.4.1) as well as outside information and that they be willing to use their own judgment.

In both cases, appropriate actions must be decided upon depending on the identified risk exposure. Directors and senior managers should take personal notes throughout the evaluation process, and the discussions should be documented so that the reasons for the



company's risk-management actions can be understood at a later time. Risk evaluations should be conducted at least annually, and if a specific risk exposure is found to be high, that area should be evaluated more frequently. If the board sees the company as being in the danger zone regarding a specific risk, the risk should be monitored and reevaluated as frequently as every board meeting—as was the case for credit and investor risks in many companies during the financial crisis.

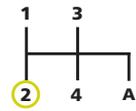
Advice

Regarding the evaluation of the risk itself, it is evident that this is a judgment call. All risk assessments are calculations of probabilities, rather than definite forecasts, and they are influenced by variables such as personal knowledge and historical events. Board directors and senior managers must rely on their experience, coupled with a diligent analysis of the available facts. If risk evaluation were a “no-brainer,” fools could run the company. But since this is not the case, risk must be evaluated with sound judgment by people with the necessary prudence, skills, and experience.

2.4.4. Build robustness into the business model and the organization

As the intended development of a company rarely goes according to plan (even if the best risk-management system and strategy are in place), the firm needs to be resilient and able to absorb some “punches.” At the same time, the underlying value-creation processes and the organization should be lean and cost-efficient. Reconciling these conflicting goals is one of the most important tasks of a board when deciding on strategic initiatives and organizational design. Some proven principles for instilling robustness are provided below:

- **Diversification of business activities:** Activities can be diversified by regions, product lines, customer groups, and so forth, or in terms of funding sources and supplies. This needs to be balanced against economies of scale (but note that there are also diseconomies of scale). Diversification requires the competence to manage greater complexity, but very often it is the most effective risk remedy.
- **Implementation of proper risk-management systems:** The board needs to supervise the company's development and implementation of a proper risk-management system and must overcome the too-common desire to let numbers and statistical models overrule comprehensive risk assessments. As mentioned above, the board must set key parameters for the risk-management systems (e.g., the risk appetite, figures such as value at risk) and supervise the implementation continuously and carefully, asking critical questions at every stage: Is the organizational process effective? Do the risk managers have sufficient standing and support from top management? Is the competence for effective risk management evolving?
- **Worst-case scenario and stress tests:** The board should develop a worst-case scenario with substantial input from management, and possibly external specialists, to see how big a crisis the company can survive. The management should also



develop a worst-case scenario for the company that can be challenged by the board.

- Crisis-management plans and exercises: The board should see that the company has proper crisis-management plans and should practice using them. Not all details of all crises can be foreseen, but nevertheless clear responsibilities should be defined, alarm plans set, and contingency support ready to be activated instantly. Special importance should be given to crisis communication (see also chapter 3.5 for details about communication under supervision of the board).
- Credibility and trustworthiness, upholding ethical standards from top to bottom: The board should ensure that the company builds up support, credibility, and trustworthiness when times are good (there is hardly time to do so in the midst of a crisis). Having built a high level of integrity will be beneficial in a crisis since this makes it more likely that a company can count on support from the outside, which can be essential to its survival.

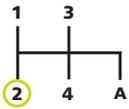
2.5.

TURN THE BOARD'S DIVERSITY INTO AN ASSET

“Our pick’n’mix board was pretty derisive and fragmented. Honestly, we didn’t listen to each other much. And suddenly we found ourselves together in a desperate fight for survival. It was the best team-building exercise ever.”—Independent director, Azerbaijan

There is well-established evidence that teamwork is most effective at the shop-floor level, but the higher you move up in the organization the more difficult it gets. Stronger individualism and egos, positioning for next career steps, representing different departmental interests, and so forth can easily make a high-level team fail. Another observable fact is the above-average failure rate of diverse teams relative to homogeneous, coherent teams. The glory of heterogeneous teams, however, is that if they do succeed, they tend to outperform more homogeneous teams (Mendenhall and Maznevski 2008; Maznevski and Jonsen 2006).

Thus, one could say that a board is the most unlikely team to succeed. When people have reached the board level they usually have pretty successful careers behind them (at least in



meritocratic societies), with the according level of self-confidence, and believe that they are usually right as they have successfully held or are still successfully holding senior management jobs themselves. Additionally, board members (especially non-executive directors) work only part-time in sessions spread over the year, which makes it no wonder that boards often do not work effectively as teams.

As stated, diversity can be a boon for boards, if managed properly. The chairman of the board plays a pivotal role in making the team of board directors successful (which will be discussed further in chapter 3.4.1). He is the guardian not only of a culture of honest debate and careful deliberation, but also of good preparation, a prioritized agenda, and the facilitation of discussions that give every argument a chance, but also lead to clear decisions.

A crisis changes a company's "business as usual" (as does, to some extent, merely preparing for a crisis). The crisis obviously affects not only operations, but also the board itself. Suddenly, the work intensity increases and even one misstep can create havoc. Things that were routine before (or were routinely ignored) suddenly become matters of life and death. The need to contribute constructively with specific knowledge and experience becomes urgent.

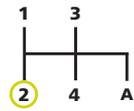
Moreover, while a variety of adjustments will happen quasi-automatically in a crisis—if the board members are aware of the crisis and are dealing with it professionally and seriously—one must not bet on an automatic adjustment of the board's behavior. It is necessary to deliberately change and reevaluate the board's work, and this can only be partially planned before the crisis.

Thus, the chairman of the board has to create the feeling (even before a crisis) that "we are in this together, and if we do not hang together, we will hang separately." But beyond style, commitment, and a dedicatedly optimistic mood, there is much more that the chairman, as the standard-bearer for structures, processes, and behaviors, can do to reinforce more constructive and value-creating board work.

Act

An experienced chairman will discover other actions as well, suited to the specific situation of his board, but the three obvious avenues are

- assigning specific tasks to board members according to their expertise,
- outlining practical and operational action points at the board level now and after the crisis has hit (e.g., scheduling new meetings, obtaining weekly reports on cash flow), and
- encouraging the board—despite the (imminent) pressure—to come up with creative, innovative ideas and a new vision for the company after the crisis.



Psychologically the board must strike a delicate balance in its deliberations: on the one hand emphasizing and articulating the severity of the crisis (which management more often than not is tempted to downplay), but on the other hand providing an aura of confidence that the crisis will be overcome successfully by the organization. A key factor in striking this balance will be the trust that the board has in top management, especially the CEO, to be competent enough for the tough times ahead (see chapter 3.2).

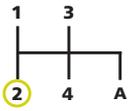
Lessons for the Road

- Good corporate governance structures and processes can help companies to be better prepared for crises. It is especially important to set an appropriate risk appetite and implement the right risk-management structures. It is the board's responsibility to supervise the implementation of all such preparatory measures.
- Even with good corporate governance structures, crises can happen. Ask rigorous questions and challenge any too-easy consensus.
- In order to reduce the probability of a crisis hitting the company with full force, board directors should always be on the lookout for early warning signs and utilize the available tools to analyze the well-being of the company.

Mini Case Study: What Do You Do if You Smell Something Fishy?

David Gush felt a bit uneasy: his gut feeling told him something was brewing, but he could not really pin down what was bothering him.

He had been on the board of the construction company BTL in Vietnam for one year now, but still had not really understood why the board had never faced any issues of importance. The CEO, Tak Verdi, had just finished his presentation about the recent business performance and the expected business development. And as usual, everything was close to perfect. Yes, profits had gone down a bit, but far less than in the industry; yes, costs had gone up a bit, but management was working to contain them immediately. The expected orders were still growing.



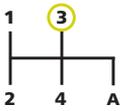
Listening to this sunny presentation, David remembered the common saying that if you think everything is on track, you obviously don't know what's going on. As the chairman commented appreciatively on the presentation of the CEO, David tried to identify what his concern really was and how he should articulate it. First, the ever-cheerful presentations of the CEO: Was he trying to hide something from the board (knowing that the chairman did not like bad news), or was he simply ignorant and presenting what his people had written for him? Second, the business cycle of the construction industry was clearly coming to an end—weakening profits and rising costs were the typical indicators. Despite this, the financial strength of BTL Construction had not improved: the cash flow had never met the investments and dividend payments in the last three years, so as a result the debt had risen over time, with shareholders' equity now at 25 percent of the balance sheet. This was described by the CEO as the optimization of the balance sheet structure ("You know, equity is expensive ..." he usually said cheerfully). David, as a "foreigner" to the construction industry (his background was in investment banking), remembered having read that the average for the industry and the requirements of banks were closer to 40 percent.

And finally, there was the bad news about the risk involved in the construction of a huge harbor project in a neighboring country, where BTL was the leader in the consortium. Despite a cost explosion and political controversies around this project, even rumors about corruption, Tak Verdi had not seen any reasons to make risk-management provisions. As usual, he assured the board that everything was under control and that BTL was not confronted with any risk.

But David had another reason for hesitation over voicing his concern: the elderly chairman seemed to be generally supportive of the CEO, as were two other "old hands" who had been on the board for decades. Only the other newcomer, a young banker named Tom Venic, had sometimes raised critical questions. But David could not even count Tom on his side: over a recent lunch, Tom had revealed that there were limits to his readiness to challenge the CEO. "You know, BTL is an extremely good customer and Tak and my boss are friends from the golf club," he told David. David himself was representing an investment fund that for several years had had a minority stake of 20 percent, but his predecessor had never voiced any concern. "It doesn't matter where you are from; as a board member, you have to fulfill your fiduciary duty to the company," he reminded himself, but he realized that this principle did not answer the question of what he should do now, and how.

Chapter 3

Managing
a Crisis



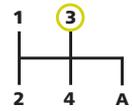
Steering Clear of Trouble

As a race-car driver you are in second place in this season's most important race, when suddenly you feel that your steering is a bit off. You definitely don't want to go into the pit now, since this would mean your certain defeat (you are almost at the tail of the first-place driver). You wonder what it could be that is making your car just a bit less smooth to drive: Is it something harmless, like a little software error, or something bigger, like the wheel itself or even the hydraulic pump in the steering? You calculate the odds—if it is only something little and you go to the pit you will move back maybe eight places; your engineers are superefficient and well trained. If it is something big and you don't go to the pit, you will still lose, because your driving will be slower and your car might stop working altogether before you can reach the pit, which means you'd be disqualified. Even worse, if the race management can prove that you knew that something was wrong and you kept on racing, they might punish you in the next race for unnecessarily endangering your competitors.

Your engineers in the pit now seem to have noticed the problem, because they radio in with a warning of your worsening lap time. You must make a decision quickly: go on as if nothing were wrong and hope for the problem to solve itself, but risk losing and even disqualification—or inform the pit and come in for an identification of the problem and hopefully a fix. In that case you'll risk losing a few places in the short run, but you'll come back to the race with the opportunity to drive much more quickly and catch up again.

Like this race-car driver, you must make the right decision if you have noticed warning signs as a board member. If you accept the reality that something is wrong, you need to find out exactly what it is in order to get it fixed, either by yourself or with the help of outsiders. Depending on the crisis, you risk losing to your competition in the short run by taking action. But ignoring the crisis might create the risk of losing to your competition in the longer run, and by taking appropriate action now, you might even end up zooming to victory.

“Once the creditors started probing in more detail our liquidity and asked for higher short-term interest rates, we understood that rumors indeed can have a bigger effect on our business than reality.”—CEO, Serbia



In this chapter, we look at five logical steps that board directors can follow if they perceive themselves to be or factually are in a crisis:

1. Accept the reality: we are in a crisis!
2. Act fast to contain the crisis
3. Modify the board and processes to adapt to the new realities
4. Assign clear responsibilities
5. Communicate your actions and solutions

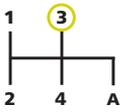
3.1.

“PERCEPTION IS REALITY”—AND THE BOARD HAS TO BRING IT INTO LINE

A paradoxical but well-established fact in business is that key decision makers, including board members, sometimes have strange ideas about the roots of a crisis, and these, unfortunately, make their actions accelerate the company's demise. In the recent financial crisis, most managers blamed every form of underperformance on the crisis. However, a recession may just brutally expose the weaknesses of a company that even the auditors had tended to ignore (to paraphrase the famous Warren Buffett, when the economic tide is going out, you see who is swimming naked). Or take the example of a production failure (the latest and most devastating example probably being that of BP in the Gulf of Mexico), where management too often tends to waste time arguing defensively and in technical terms or even blaming the whole issue on the media frenzy. The real problem for the company is not only the production failure but the consequent loss of customer confidence and of the trust of regulators and shareholders or a mismatch between the brand's promises and the actual experience it delivers.

Even worse, by blaming the crisis on others and on external factors, top managers overlook an important fact: “Perception is reality!” Although this is often deemed unfair, managers should be aware that the company is affected by the crisis if the public, or the staff, believes it is. Once trust in the company is lost, whether through rumors or facts, the company risks entering a downward spiral as one stakeholder after another loses confidence in it. Investors withdraw their money, creditors don't extend credit lines, customers start shopping around, suppliers want tighter payment conditions—and, compounding the company's perception problem, the media, regulators, and NGOs want their share of public attention.

This problem is especially visible for ethical issues in companies already shaken by crisis, even though these issues may have been handled according to the letter



of the law. A prominent recent illustration of this was the payment of bonuses to top bank managers. While the payments were legally and contractually sound, the media relished covering these stories and the public reacted by withdrawing money from the banks concerned (the Swiss bank UBS lost its number-one status in wealth management as a result).

As described in the previous chapter (see especially chapter 2.2 on types of crises and 2.4.1 on early warning signs), it is the board—if sufficiently independent from the senior management and, in some cases, of the controlling shareholders—with its wealth and diversity of experience, that has a broader view and can cut through the company insiders' self-defenses, blame-passing, and “cover my back” arguments to let the facts speak the brutal truth. Cover-ups don't work, so it's better to just deal with the messy process and get it over with. The board should focus the hearts and minds of the whole organization, but especially senior management, on two key questions:

- What needs to be done immediately to survive?
- What is required to emerge stronger after the crisis?

These are normally not questions with quick-fix answers—although the answers are needed quickly. The board needs to drive this process by insisting that everyone involved confront the unpleasant facts and by preventing management from running into blind alleys or only searching for scapegoats. And obviously, the board needs to test and probe the actions management is suggesting before embarking on a rapid implementation.

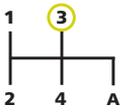
3.2. ACT TO CONTAIN THE CRISIS

Speed is of the essence in managing a crisis. This means that even the board has to work overtime. Physical presence is not required for all of these extra hours—that can be reserved for key decision-making sessions. Updates, feedback, and reviews of the latest data can easily be done via telephone or video conferencing. However, this requires that the board has worked before as a team and has exhibited a culture of open and honest debate!

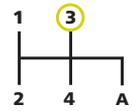
Once the existence of the crisis is recognized, the company needs to get its act together to undertake measures aimed at containing it or its most dangerous attributes. Below are nine measures board members should consider when trying to contain a crisis (based on James [2002]). Not all steps are relevant and necessary in all crises, as they depend on contingencies such as the management's capabilities or the severity of the crisis (such details are covered in the next section). Yet they give a good overview of what can become necessary to contain the crisis.

Act

1. **Stop the bleeding—no matter what type of crisis!** No more cash should go wasted, the outflow of information (e.g., to the press from unauthorized personnel) must be stopped, the flight of key personnel to other organizations should be slowed, and so forth. Take the example of cash flow, where strict control must be enforced: this can include curtailing expenses for traveling and marketing and even stalling bigger investments for expansion. This also applies to executive and board pay, which is under closer scrutiny by the public and the government in crises. Hence, board expenses, bonuses, and pay must be bulletproof and clawback provisions must be put in place (to allow the company to recoup incentive pay at a later stage if the numbers develop differently than envisaged).
2. **A proper solvency report should be commissioned** from a major accounting firm with experience in quick crisis work. The solvency report should above all reveal the company's cash needs (cash is what becomes the primary "make-it-or-break-it" factor in a crisis situation), as well as the company's balance sheet, assets, and long-term liabilities. This is important in both "bullet" and "bomb" crises (presented below in chapter 3.3.1). Take the example of BP; the cost of the oil spill (a bullet crisis) is threatening to tear the company apart. The stress tests that have become mandatory for banks in both the United States and the European Union are extended solvency reports that test, among other things, banks' liquidity reserves against various bullet and bomb crisis scenarios.
3. **Think about sweeping out old leaders.** Leaders who are reluctant to change, in denial, or clinging to their comfortable position and unwilling to change their opinions should not be tolerated for too long (e.g., they should be given a two-week period to come up with solutions). In this regard, a crisis can even be seen as an opportunity to remove people who have stopped adding value to the company.
4. **(Re-)assign responsibilities and authorities** to internal and external experts (e.g., a crisis-response team; see chapter 3.4.5), and in particular to the hidden heroes in the company—those people who have been driving the company forward but have neither been rewarded properly nor been particularly in the spotlight. Obviously, finding the hidden heroes is a difficult task, and not only for non-executive directors. Usually they are people who have been working in the company for a long time, who have a vast internal network and are trusted by most people (after all, they are competent but have not shown too much competitive ambition). In any case, clear responsibilities and authorities help everyone in the company understand who calls the shots and whom to listen to.



5. **Make decisions about how to move forward** and actually get out of the crisis (with the time after the crisis in mind, of course). As a board member this can mean both making the decisions and clearly supporting the decision-making process and the consequent actions. Obviously, making decisions under stress and with incomplete and constantly changing information can be more than difficult. But remember, making no decision is usually the worst decision. Directors should in any case help to prioritize resources and decide on the problems that need immediate attention. After all, only by making (sometimes tough and unpopular) decisions can directors help overcome the paralysis that dooms so many organizations in a crisis.
6. While making decisions, it is necessary to be prepared that plans might go awry and hence strategies might need to be adapted. Thus, **having a Plan B is an absolute must**. A Plan B gives you the comfort of being able to react to new developments and opens space for negotiations (e.g., with creditors or investors).
7. **Get more than enough cash to survive the crisis**. It is no use to run to investors or creditors too frequently with “new” information, since this definitely impedes trust and credibility (which are especially important in crisis situations). Hence, getting enough cash at the outset of the crisis often makes a big difference to the survival of the company.
8. **Communicate the crisis-response plans** throughout the company and to the relevant stakeholders (e.g., shareholders, banks, employees, and regulators). Finding a clear communication strategy is a balancing act between admitting faults (and hence risking lawsuits) and lacking transparency (and hence risking loss of credibility). Yet, especially in crises, communication from the highest echelon of companies does help to build trust, if it is done properly and the company speaks with “one voice.” Also, the board must ensure that employees do not learn about the crisis and its consequences through the media, but directly from management (see also chapter 3.5).
9. Finally, **set a “deadline”**—the time at which the company should quit throwing good money after bad. It does not make sense to fight for the survival of a company that can’t be rescued. In the end, not only will the investors lose out, but the individuals involved in the company will lose their reputation and credibility.



3.3.

FOCUS ON HOW THE BOARD CAN ADD VALUE

“In the last year, we doubled the number of board meetings and I met weekly with the chairman and his deputy. I would not like to go through a crisis without such feedback and assurance. But I don’t want to maintain this either once business is back to normal.”—CEO, India

The key question that determines how a board works in a crisis is pretty simple: How has the board worked before? A crisis tends to reinforce and intensify existing patterns of decision-making processes, behaviors, and interaction with management and other key stakeholders.

If a board has not been adding value, but just rubber-stamping executives’ decisions to satisfy the legal formalities, its insignificance will be demonstrated more clearly during the crisis: top executives are far too busy to care about the board, take the time to inform it, or ask it for advice and support.

On the other hand, if the board has been functional and adding value before the crisis, the relevance of board work will increase: meetings will be more frequent (not necessarily in person, but at least via telephone or video conference), the information flow will increase, and the reporting metrics will be adjusted (e.g., with a much higher focus on cash flow and liquidity than in normal times).

A good board will contribute the wealth of its experience to serve as a “sounding board” for new ideas, to coach management, and to bring additional motivation in difficult times. Most important of all, as the board is not so absorbed by the additional management work that piles up in a crisis, it can take the “luxury” of looking beyond the crisis and guiding the company in such a way that lessons are learned from the crisis and are implemented. This should help the company to be more competitive than before the crisis. Correcting the myopic tendencies of management in a crisis situation might be a board’s most valuable contribution.

3.3.1. How the board should work in different crises

Boards work in different ways, depending on the four shaping factors of corporate governance (see chapters 1.3 and 2). Crises also come in many different forms (see chapter 2.2). In order to make sense of the myriad potential contingencies, Figure 3 distinguishes four typical paradigms for the actions of the board in response to different types of crises.

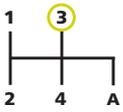
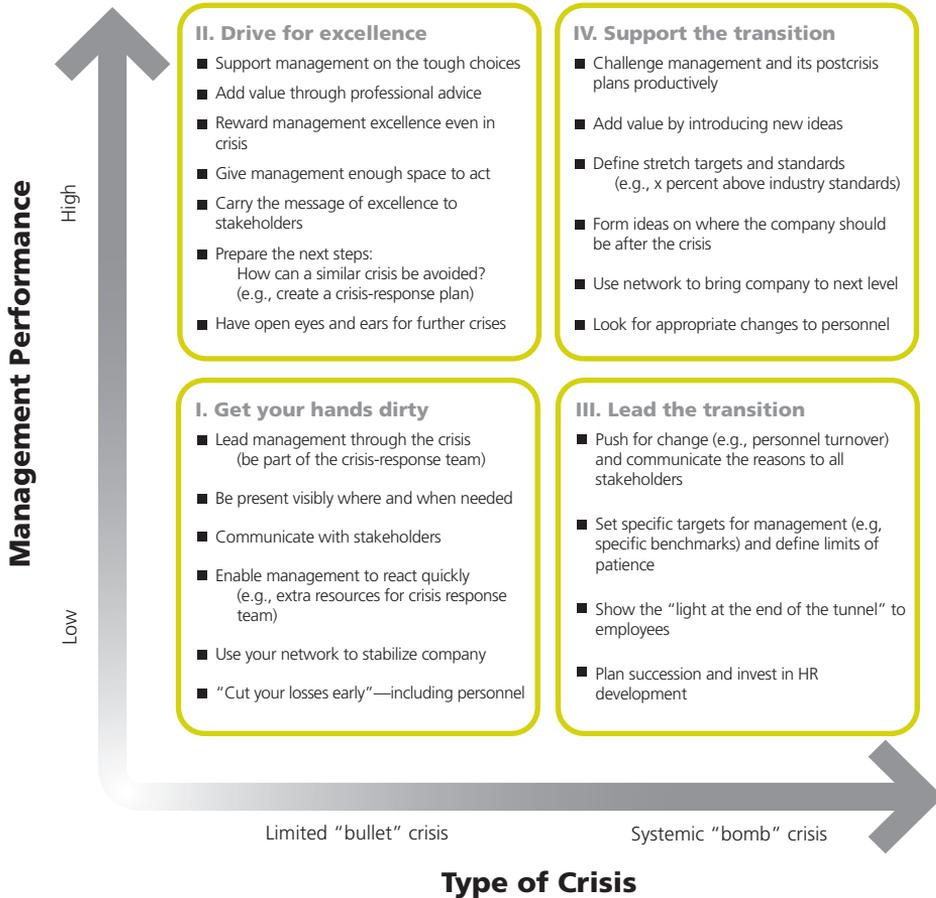


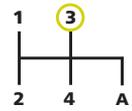
FIGURE 3: Contingency Approach to Crisis Management



As illustrated in this figure, two factors defining the involvement of the board in crisis management are paramount:

1. the competence of top management to master the extraordinary challenges of a crisis, and
2. the breadth of the impact of a crisis on the company.

The first factor should be self-explanatory, but the second requires some definition. A crisis can be very specific, hitting only one area of operation, subsidiary, product line, or business unit. Yet, despite the narrow focus of this type of crisis, it can have a severe and considerable impact on the company. Because of these characteristics, this is termed a "bullet" crisis. The



2010 BP oil spill in the Gulf of Mexico is a typical bullet crisis, with a very specific problem that carries severe consequences for the company as a whole.

In contrast, a “bomb” crisis has a much broader impact, shaking the fundamentals of the business model and the company’s profitability drivers and reshaping the whole competitive landscape. This type of crisis happens often when latent, structural industry problems emerge during a downturn or when a disruptive innovation or regulation is brought to the market. A potential source for bomb crises, especially for Western companies, is the frugal innovation coming from emerging economies, such as low-cost cars like the Indian Tata Nano, generic drugs, or “mobile money” (the use of mobile phones to make payments, pioneered in Kenya). These innovations could threaten the business model of companies in developed economies producing technology-laden but sometimes user-unfriendly products.

Thus, bomb crises reveal significant changes in markets, technology, customer behavior, and other business factors that were barely noticeable before because of their incremental evolution over a long period of time. When these developments reach the crisis level, the need for an adjustment or even redesign of a company’s business model suddenly becomes much clearer and more pressing.

The discussion below goes into more detail regarding what the four crisis contingencies shown in Figure 3 mean for the work of the board.

Quadrant I: “Get your hands dirty”

In this scenario the trigger of the crisis is a severe but limited event—a bullet crisis: for example, a major product recall, a scandal, a devastating accident or fire, a major act of fraud or violation of a regulation, or a liquidity crunch due to mistakes in funding. Unfortunately, either management is divided, paralyzed, or unwilling to find sustainable solutions or the event has revealed a severe competence gap. Even worse, management in such situations is often stuck in group-think and denial and blames others for the crisis. For various reasons (e.g., time constraints or ownership structures; for further reasons, see the text box “When to Fire the CEO” below), the board cannot or will not change management in the short term.

Thus, the board must assume a type of conceptual leadership that addresses the root causes of the problem at hand. The board should not allow an easy way out for management (e.g., by just punishing some subordinates). It is key for the board to expose management to different thinking quickly (i.e., to provide an “eye opener”), to help them understand the negative reactions of staff, customers, and other stakeholders to their behaviors. This can be done in informal meetings where the chairman invites experts or representatives of different perspectives for informal discussion with management. In such scenarios it is often important to ensure that management is not “losing face.”

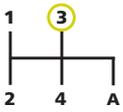


FIGURE 4. Quadrant I: “Get your hands dirty”



When to Fire the CEO

In a crisis, the instinctive reaction of the board is often to fire the CEO and change top management. But before a board (in cases of majority ownership, in coordination with the controlling shareholder[s]) jumps to that conclusion, the directors should think twice.

First, to many in the organization and to outside stakeholders, this will look more like sacrificing the scapegoat than finding a solution to the problem. When the crisis is one that has evolved over time, many people have been involved in it—probably the board, too. So it is not rational to blame only one person.

Second, who should replace the fired CEO or top managers? Even if there are people available, how long will they need to learn before they can really make a difference? In most companies, unless there has been thorough succession planning

for these key positions (which is the responsibility of the board), there will not be a compelling case for inserting new personnel immediately.

However, there are situations where such dramatic action is unavoidable. This might be the case when the CEO is personally part of the crisis (e.g., involved in “cooking the books”) or has lost all support in the organization because of a series of ill-conceived decisions. In such situations, longer deliberation by the board is poisonous for the organization. Either the evidence is so clear that the decision can be taken on the spot or the board must continue to work with the CEO but increase the intensity of its scrutiny.

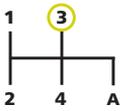
Of course, the board only has the authority to take such actions if the positions of the CEO and the chairman are separate and the CEO is not linked to the owners (e.g., as a member of the owning family). In those cases, the final decision will be taken within the circle of owners, but the board, since it is usually closer to the corporate operations than the owners, can nevertheless play a decisive role.

Given the difficulty of changing a CEO in a crisis on short notice, it is more important that before a crisis hits the board is on the lookout for the characteristics of a “Siegfried CEO” (see chapter 2.3.3) and has a succession plan in place.

Very often processes need fundamental change or priorities need to be shifted (e.g., in cases of lax enforcement of safety rules or quality gates). Board resolutions on such changes should be as detailed as necessary, even prescriptive for management, but still the board should resist the temptation to manage the issue itself (e.g., by actually writing the new safety or quality process rules). If needed, it can form an ad hoc committee to deal with the processes in question and to have the necessary in-depth discussion with management. In any case, the board must set clear goals with clear timetables to fix the problems and must take actions to supervise their implementation on a regular basis.

The supervision by the board should ensure that the implementation of the new rules goes quickly and is made to stick. So clear and probably repeated communication by the board about the causes of the crisis and the lessons from the crisis is essential.

As an example, imagine a crisis at a firm in an emerging economy caused by an important customer’s product recall, for which the firm is held responsible because it delivered a part that was regarded as faulty. The first thing the board must require from management is a rigorous analysis of the root cause (not just why the part was defective, but also why it slipped through quality control) and an investigation of similar risks, to determine whether this defect also occurred in other instances or with other customers; remember that a crisis never



comes alone. Second, the board must decide on the path toward a solution, not in technical detail, but providing conceptual leadership (and clearly letting management know that this is being done because management is not trusted to meet its normal responsibilities). This path might include goals such as ratcheting up the quality level and strengthening independent quality reviews. Third, the board must supervise the implementation of the solution rigorously and look for the procedural and cultural changes that are needed to make the new solution “stick.” This task could be delegated to a special ad hoc committee of the board that consists of the board members with the most experience in the relevant field (another reason why board diversity is a good thing).

At the end, the board should conduct a postaction review together with management, to discuss the “lessons learned,” the enhanced crisis-prevention system, and last but not least, how management competence can be developed to close the gaps revealed.

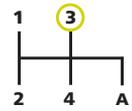
Quadrant II: “Drive for Excellence”

In quadrant II, the company is again confronted with a bullet crisis. In contrast to quadrant I, in this scenario the board can rely on competent management and believes management is capable of dealing with the crisis—a much more comfortable position.

Nevertheless, in this situation too, the board must deliver considerable value to the organization, by doing its part in solving the crisis and ensuring that the company

FIGURE 5. Quadrant II: “Drive for Excellence”





emerges from the crisis stronger than the competition. The board can, to some degree, still coach even competent management: its external perspective and the broader information base it can draw from is normally helpful for any top management team—especially a team that is immersed in action and has trouble “seeing the forest for the trees.” The second job for boards in this scenario is to ensure the sustainability of the solutions to the crisis and to supervise their implementation, since management often moves (too) rapidly to the next “burning” issue. Thus, the board has to prevent the unfortunately common situation in which the urgent is crowding out the important. In agreement with top management, the board in this crisis situation can also take over specific tasks, especially communication with important external stakeholders, since board members (those who are sufficiently independent and don’t represent a shareholder) are often regarded as more neutral than management. However, the board should abstain from taking over communication with internal stakeholders (employees), since this is the prerogative of management.

A delicate issue comes up for the board if it does an annual performance evaluation of the top management: How much should the crisis influence bonus considerations, especially if the damage to the bottom line was, at least in the short term, very limited? Important longer-term, “soft” factors like reputation and customers’ trust are more difficult to measure or assess. Unfortunately there is no easy solution to this issue, since boards hold management accountable for different deliverables in different companies. However, one option is to withhold some part of the bonus and pay it out when the impact of the crisis is fully visible and the consequences have been successfully managed.

Quadrant III: “Lead the Transition”

Here the situation for the board is the most difficult. The company is confronted with a bomb crisis that has revealed some fundamental flaws in the business model or massive mistakes in the implementation of a major strategic initiative. The board has, or should have, no trust anymore in the capability or willingness of top management to lead the urgent transformation process. Therefore, the board must immediately get heavily involved in solving the crisis, even to the point that some board members take over temporary management positions (in crisis situations this is often legally accepted for a limited time, even in otherwise strictly separated two-tier boards).

At an appropriate occasion, the board must reflect on why it allowed the problem to develop into a crisis. But the key questions for the present moment are, How much time and energy can the board invest to coach management and take responsibility for decisions that are normally the prerogative of management? How far can the board shift the line between executive management and board oversight to extend its decision-making power? And the following question should never be forgotten: When is it time to scale back the intensity of board supervision and involvement to a more normal level?

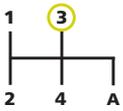
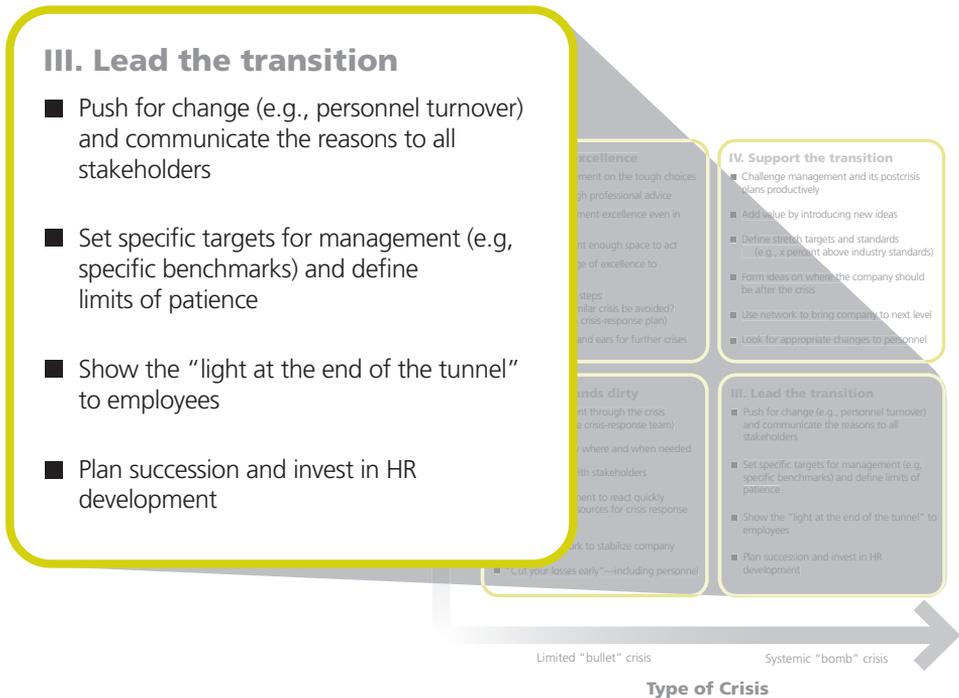


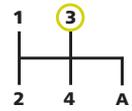
FIGURE 6. Quadrant III: “Lead the Transition”



These questions hardly have universal answers. The board should consider them monthly or more often in a crisis situation, since only exceptional circumstances justify such massive involvement of the board in day-to-day management.

A good way forward in such a situation is to rapidly construct and analyze the worst-case scenario—that is, the outcome for the company under the worst possible development of the crisis (similar to a stress test, discussed in chapters 2.4.4 and 3.2). Almost always, at the beginning of a crisis its depth and duration are underestimated. The worst-case scenario must define the “bottom,” particularly in terms of customer and supplier relations (e.g., in a recession, not only do business partners go bankrupt, but terms of payment also get worse, leading to the need for more liquidity when this is least wanted), and look at key personnel and emergency replacements for them in case they “jump ship” or even sabotage the rescue efforts. The board should also look out for other potential surprises (remember the saying, “Recessions reveal what the auditors did not”).

Based on this worst-case scenario, the board should develop a step-by-step response plan. Such plans should include different responses keyed to different levels that the crisis might reach: for instance, at level 1 (say, a sales decline of 10 percent), all training activities



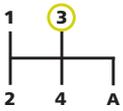
are stopped, travel is restricted, investments are cut by 5 percent, and working capital is proportionally reduced. At level 2 (say, a sales decline of 20 percent), more rigorous cutting of all expenses that are not needed to maintain core operations becomes necessary. This stepwise action program needs to be communicated in advance to the managers in charge (and perhaps also to employees and investors) at least in its basic features, if not in detail, to demonstrate the company's preparedness and to avoid a situation in which the organization is constantly facing new initiatives, which creates a sense of disorientation and even panic.

Special attention should be paid to liquidity and emerging funding needs; these should probably be monitored weekly, and sometimes even daily. Remind the whole organization that "you can live a year without profit, but not a second without liquidity." Therefore, the cutting of costs needs to be analyzed not just for the general reduction of expenses. Much more immediate effects on liquidity and assets need to be scrutinized, to see whether these can serve as collateral in case more credit is needed (though normally it does not make sense to sell assets in a crisis at "fire sale" prices).

Often, critical choices need to be made if the company has customers who are late with payments or have never been profitable, but whom the organization has until now not wanted to "dump" to keep sales figures up. Other crucial steps include the renegotiation of contracts with suppliers and, often most critically, discussions with banks or other financial intermediaries, including new shareholders or even majority or controlling owners (this of course depends very much on the ownership structure; in cases of concentrated ownership, it will require the involvement of shareholders or their representatives).

The board will also find itself in the uncomfortable position of having to communicate extensively with employees, customers, and other stakeholders. In the beginning this will mostly entail delivering bad news (and being confronted with the question of what the board was doing to avoid the crisis). At the same time, it is important for the board to identify and communicate "areas of hope" and future growth and to tell stakeholders why the actions that are being proposed and taken will leave the company stronger once business comes back. It is most critical to formulate a unified board message and decide who is delivering what information to whom.

After defining the appropriate actions, the next important issue for the board is its changing relations with management. Whereas specific actions can be based on previous experiences of board members or checklists (for some references, see the bibliography in Appendix D), changing relations with management is a unique problem in every company and more psychological than empirical. After all, in such severe crisis situations, the management is clearly downgraded to the role of implementer of detailed board decisions, and sometimes even (temporarily) replaced by board members. This can trigger all kind of responses from management, up to and including sabotaging the board's decisions by distorting the arguments for its actions (or just keeping silent instead of providing any explanation to staff), implementing the decisions sloppily, or not fine-tuning them to the



needs of specific markets or organizational units—all just to prove that they were right and the board was wrong. One such example that was recounted to the authors was a head of personnel who, in order to accomplish the required headcount reduction in his department, fired the whole unit. Since this unit was responsible for the processing of monthly wages, this created a lot of additional friction with employees, who received their money late and with unexplained deductions.

To avoid having management and staff become paralyzed or even begin sabotaging the recovery effort, the board needs to be careful in communicating with them about the necessary adaptations and changes of processes and structures.

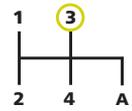
Quadrant IV: “Support the Transition”

As in quadrant III, the company is confronted with a bomb crisis. However, in this scenario the management is considered competent to manage the crisis and take the company’s business model to the next level.

Despite these slightly more favorable conditions, the board must be aware that this crisis has such a broad impact on the company that basic characteristics of the business (e.g., regulation or technology) have fundamentally changed. This, again, is a situation where the board needs to take a conceptual leadership role.

FIGURE 7. Quadrant IV: “Support the Transition”





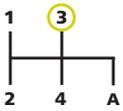
Especially if the top management is under extreme stress (as it normally is in a crisis), the leadership and feedback delivered by the board can be important to increase its confidence and resilience and improve the quality of the actions taken. Beyond this, the board should dedicate itself to adding value by conducting well-grounded work on the question, How can the company emerge stronger and faster from the crisis than the competition? As management is doing most of the day-to-day work in this form of crisis, the board needs to deliver value in a different way.

The question of the future strength of the company should guide not only cost-cutting actions, but, even more, changes in the business model. And since management rarely focuses on such topics (for obvious reasons in a crisis situation), it is the board that has to step up to this task. The board has the privilege of the long-term view and needs to integrate its findings with the short-term actions proposed by management. In this case, the deliberations of the board should focus on three central questions:

- What are the new drivers of profitability and how strongly is the company affected, given the current business model? For example, if the market is shifting toward “commoditization” and the company has a high cost base justified by product differentiation, the company will be under pressure to change with the new environment calling for a lower cost base.
- What are the emerging new customer segments that have new requirements or the new technologies that will allow for a different value-delivery system in the future? For example, a change in customer preferences from brick-and-mortar shopping to online shopping changes the supply chain from a middleman-based system to Web-based purchasing and direct delivery.
- What are the company’s key competences that can be leveraged under the new conditions, and what areas of competence need to be built up urgently?

Once these three questions have been clarified in their most important respects (the board should not get too far into the details, especially with competent management) and the worst of the crisis is over, the next steps and the necessary changes need to be discussed with top management in order to get their buy-in. Furthermore, all parties must agree on the process of validation and rigorous testing of the agreed-upon actions. Once this is done, the board needs to set the vision for the company’s future, with clear goals and timetables. This is especially important because management often tends to minimize changes and slow down their pace in order not to destabilize the organization. As many issues remain uncertain and new challenges arise along the way, intensive communication and honest debate between the board and management are particularly needed; after all, this will be a shared learning process.

In every contingency, the time dimension of the board’s decisions needs to be carefully



considered. Often short-term actions can be counterproductive in the longer term. A typical example is the temptation to cut back on research and development (R&D), which could easily lead to a competitive disadvantage in years to come, when a key competitor comes to market earlier and reaps all the “first mover” advantages. The opposite is also true: what helps in the long run might not be helpful in the short term, when liquidity concerns overwhelm all other criteria. A company might need to “mothball” an investment despite the considerable cost of doing so and the need to have that new capacity available in order to remain liquid and avoid bankruptcy when the market comes back.

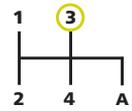
Such decisions in a crisis are full of dilemmas, which cannot all be discussed here in detail. The main point to remember is that the board should deliberately ask management to separate the longer-term implications from the shorter-term consequences of suggested actions so that they are transparent to the board and the board can balance conflicting demands as much as possible or limit certain actions explicitly to the crisis situation (e.g., the elimination of expenses for training and continuous qualification, which are often an “early victim” of any cost-cutting exercise).

Another important point is that as in normal business situations, in crisis situations the leadership of the company shifts between the shareholders, the board, and the management, depending on the four shaping factors of corporate governance (personalities, the business model, capital markets or ownership, and regulatory framework; see chapter 1.3.2). In a crisis situation, the biggest driver of the changing division of labor between the board and management is the competence existing in the company. However, the board must be willing and the management able to redraw the line once the crisis has passed.

3.4.

ASSIGN CLEAR RESPONSIBILITIES TO THE DIFFERENT PLAYERS

“To define the role of the board in the crisis was very difficult—not only because we lacked crisis management expertise. Nobody knew what his or her role was and who was responsible for what. Only when we assigned accountabilities we were able to steer the company clear of disaster.”—Board director, Azerbaijan



This section presents the different roles, responsibilities, and suggested actions of the chairman, the non-executive directors, the corporate secretary, the shareholders, and the crisis-response team in a crisis situation.

But first, let's revisit the board's role in any legal framework. The board must provide three core functions:

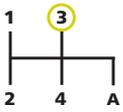
- Set the overall direction for the company and define strategy, goals, risks, and the basic organizational design, defining key responsibilities and accountability in the organization
- Supervise the implementation of strategy and the performance of management and intervene in cases of insufficient performance
- Hire the top management and set incentives for their performance

However, especially in many midsize companies, but even in larger ones, this role is not well developed and differentiated from daily management. In many cases one shareholder—or a small group, often the owning family—is the dominant shareholder and also assumes management positions. The majority of non-executive members on the board are often nominee directors (there to represent a specific shareholder group) or are in other ways related to the owners and the top management. Only a minority of membership is both non-executive and independent. This is also rarely the case for the chairman, who is often entangled with the majority owner, management, and sometimes even both at once.

3.4.1. The role of the chairman

Observers and practitioners agree that the way the chairman runs the board is decisive for the amount of value added by the board's work. This has two dimensions: first, he sets the tone of the discussion, determining whether there is honest, rigorous debate and whether the board tests management's assumptions and conclusions, addresses dilemmas early, and names performance gaps and unresolved issues. Second, he organizes—with the support of the corporate secretary (see chapter 3.4.3)—the board's work, allocating time for debate based on the importance of the topic, making sure that strategic issues are covered systematically (e.g., by setting a board calendar), and ensuring the delivery of timely and comprehensive information to board members. The role of the chairman in emerging-market companies is clearly facilitated when he is a major shareholder or in a trusting relationship with the major shareholder, since that makes the coordination of the board's work with the decisions of the general meetings of shareholders (which often have the prerogative to make the final decisions on important topics) easier and quicker.

The situation can be more difficult if the chairman is also the CEO, as these are often conflicting roles (a topic hotly debated, but not discussed here in detail). Executives tend to focus more on their own responsibility than to involve the board in important issues early on.



The chairman needs to step up his direction of board work during crisis situations. Table 8 shows the chairman’s responsibilities during normal situations and his additional responsibilities in a crisis.

TABLE 8: The Chairman’s Role

Day-to-day responsibilities	Crisis responsibilities
<ul style="list-style-type: none"> ■ Leader: <ul style="list-style-type: none"> – Ensuring that the board is effective in its tasks of setting and implementing the company’s direction and strategy – Chairing general meetings of shareholders and board meetings, and setting the agenda – Taking a leading role in defining corporate governance structures and processes and making sure that the best possible practices are observed ■ Funnel: Ensuring that the board receives proper information, keeping track of directors’ contributions to the board’s operations, and involving all directors in discussions ■ Mediator: Ensuring the link between the board and stakeholders, summing up meeting results, and building consensus to help reach decisions ■ Representative: Acting as a leading representative, especially to those outside the company ■ Gatekeeper: Drawing a clear line between the board’s and management’s responsibilities, and defining the acceptable limits of shareholder involvement 	<ul style="list-style-type: none"> ■ Supporting management or fully taking responsibility in discussions and negotiations with key stakeholders ■ Helping the company to regain its credibility ■ Checking on the company’s performance more often and acting accordingly ■ Taking responsibility for the board’s shortcomings and adapting structures/processes accordingly ■ Appointing and possibly leading a crisis committee or crisis-response team ■ Changing the schedule of board meetings as necessary ■ Helping directors to overcome biases ■ Looking for successors for top management positions, if necessary ■ (Re-)drawing a clear line between the board’s and management’s/shareholders’ responsibilities

3.4.2. The role of the non-executive directors

“Maybe we would have returned too early to ‘business as usual’ as sales recovered. It was one engaged outside board member who rightly prevented this by his pertinent questions. In hindsight, it was right, but sometimes I was really tempted to cut him off.”—Board chairman, Ukraine

Before focusing on the role of the non-executive and independent directors, it is important to stress that the legal and moral obligation of all board members is the same: to act in the best interests of the company on whose board they serve, to use the information that is available and search for more, to apply their best knowledge and experience, and to treat all shareholders and stakeholders with fairness and respect for their rights. Independent and non-executive directors—the number of whom is often subject to a quota in larger companies by law—are expected to serve as “guardians” and role models for these tasks and behaviors. They definitely need diplomatic and persuasive skills to convince owners, nominee directors, and management that the observation of these principles is in the best interests of the company and should be part of the board culture, and also that they have specific competences that add value to the decision-making process. They can bring in additional information, based, for example, on their experience in other industries. They lack the detailed knowledge of the business that the company’s executives have, but their distance often allows them to recognize patterns, turning points, and warning signals much earlier than insiders.

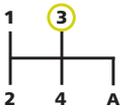
All non-executive directors have distinct responsibilities and tasks as board members relative to executive members of the board. Table 9 shows the non-executive directors’ responsibilities during normal situations and their additional responsibilities in a crisis.

TABLE 9: The Non-executive Directors’ Role

Day-to-day responsibilities	Crisis responsibilities
<ul style="list-style-type: none"> ■ Strategy: Challenging management constructively and helping develop proposals on strategy to shape the future of the company ■ Performance: Setting performance goals, scrutinizing the performance of management in meeting agreed-upon goals and objectives, and monitoring the reporting of performance ■ Risk: Ascertaining the integrity of financial information and ensuring that financial controls and risk-management systems are robust and defensible ■ Preparation: Staying prepared and informed about the company and the external environment in which it operates 	<ul style="list-style-type: none"> ■ Asking even more pertinent questions, even as they become painful and seem annoying ■ Helping to overcome paralysis in reaction to the crisis ■ Recognizing the responsibility of the board in preventing the crisis and establishing crisis-management procedures ■ Helping the board to admit failure, lenience, and sloppiness if appropriate in order to learn for the future ■ Upholding the highest ethical standards of integrity and probity ■ Supporting executives in their leadership of the business

3.4.3. The role of the corporate secretary

The board needs legal, administrative, and process-related support to fulfill its obligations. This task is assigned to a position that in many legal frameworks today is called “corporate



secretary” (other names used, especially in larger companies, include “corporate governance officer” and “board secretary”). Often, the job is part time and is assumed by the head of legal affairs or general counsel, since it clearly calls for knowledge of the relevant corporate laws and their specific requirements, from the formal requirements of the invitation to the general meeting of shareholders to the need for documentation of board decisions.

The larger the company (or its international activities), the more important the role of the corporate secretary becomes. Even the best intentions for board work can easily be derailed if processes are not implemented properly (see Erismann-Peyer, Steger, and Salzmann 2008).

Table 10 shows the corporate secretary’s responsibilities during normal situations and her additional responsibilities in a crisis.

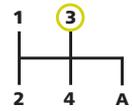
TABLE 10: The Corporate Secretary’s Role

Day-to-day responsibilities	Crisis responsibilities
<ul style="list-style-type: none"> ■ Ensuring the supply of information to the board (e.g., going after individual departments to deliver on time) ■ Making suggestions for the agenda (e.g., by reviewing the implementation of the board calendar) ■ Coordinating the agenda and timing of committee meetings ■ Drafting resolutions and board reports, based on instructions by the chairman or the board 	<ul style="list-style-type: none"> ■ Ensuring with greater urgency the timely dissemination of information ■ Organizing more frequent meetings (which requires schedule coordination for busy people) ■ More quickly producing and distributing the minutes ■ Reacting flexibly and organizing extraordinary meetings ■ Communicating board decisions within the organization

3.4.4. The role of shareholders

Since the shareholding structure in many emerging-market companies is very concentrated, the cooperation of boards and shareholders is different than in more developed countries, where boards represent as fiduciaries a very fragmented shareholder base.

The coordination between boards and shareholders is of course easy when all shareholders are represented on the board. But in many cases only some major shareholders are on the board (e.g., the controlling or founding family), while the (often numerous) minority shareholders are not. In other instances, the shareholders have designed the board as a purely professional body and are not directly represented on it. In any case, the coordinating mechanisms that work in good times are not sufficient in a crisis situation, when rapid, far-reaching decisions need to be taken.



The key person to coordinate with shareholders is, of course, the chairman of the board. He must ensure that on the one hand the board is living up to its responsibilities and not being sidelined by powerful shareholders, and on the other hand that there is consensus between the board and shareholders.

Therefore, early on, the chairman has to clarify the following questions with the shareholders:

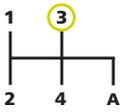
- Is more money available from the shareholders in the worst-case scenario, especially when bank lending dries up?
- How much confidence do the shareholders have in the top management and in the board? This shapes the relationships in a crisis: Do the shareholders stay detached, trusting the board and management to sort out the crisis, or do they ratchet up their involvement, even sidelining the board and giving direct and detailed instructions to management?
- Are the shareholders insisting on the independence of their companies or are they open to M&A options?
- What are the shareholders' expectations for information flows and for the frequency and depth of information, and how can decision making be rapidly coordinated? One option in a crisis, for example, is that the board and shareholders meet together, although technically (for legal purposes) in two separate meetings; another option is to inform shareholders of the board's decisions immediately and give them some time to object.

The job of the chairman is very difficult if the controlling shareholders disagree on the fundamental response to the crisis (e.g., some want to sell immediately, others want to weather the crisis) or if the minority shareholders are numerous. Often, and not only in crisis situations, conflicts of interest emerge between the controlling shareholders and the small minority shareholders. In any case, the board has to tread very carefully and ensure that the controlling shareholders do not abuse the small shareholders. Here the ability of the board to represent all shareholders can really be put to the test.

Advice

3.4.5. The role of the crisis-response team

"Honestly, the crisis-response team the board formed was not very helpful at the beginning. At first, we wanted to abolish them, but then we found that the composition was not up to the task and the role was just not clearly defined,



especially against management. Thanks to the fixing of these issues, the crisis-response team could help and the business survived.”—CEO, India

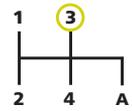
During a crisis, a board might decide to form a special committee, a task force that can include external experts, as a crisis-response team. The formation of such a team becomes especially necessary when

- existing management must concentrate on the continuation of normal operations,
- conflicts of interest in the management (and board) must be overcome by assigning responsibility to outsiders, or
- possible and actual legal impeachments of the management must be dealt with properly.

The composition of a crisis-response team depends on the type of crisis, the type and capabilities of management, and the specifics of the corporate governance system. Thus, a crisis-response team can have a variety of members:

- The CEO and her direct reports, including the CFO
- The chairman of the board
- Directors (including non-executive and independent directors) on a board committee charged with crisis response
- The company's general counsel
- Outside counsel (e.g., a board advisor on fiduciary duties, a criminal defense lawyer specializing in regulatory issues)
- A private investigation firm
- Public relations advisors
- An investment banker
- Industry experts

External experts become especially necessary for a crisis-response team if the board feels that the capabilities, expertise, or knowledge to solve the crisis is not present in



the company or that the personnel are already overstretched. If the board believes that such capabilities are in fact present in company personnel and that these people are available for use for a crisis-response team, not entangled in other operations, hiring external resources should not be pursued too strongly. After all, hiring a crisis-response team must be well thought through in terms of cost and returns; especially in crises that revolve around stabilizing cash flows, spending money to hire outside expertise does not contribute to the stabilization. Yet, hiring an experienced crisis-response team can have several benefits:

- Adding credibility to the company's willingness to solve the crisis
- Adding knowledge about and experience in crisis response
- Speeding up the crisis response and solution
- Avoiding mistakes (e.g., in communication)
- Letting personnel concentrate on operations, rather than on the crisis

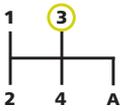
Once a crisis-response team is formed, it needs to be endowed with clear responsibilities and authorities in order to work efficiently. These responsibilities depend on the original reason for forming the crisis-response team, and thus on the type of crisis (bullet or bomb), the capabilities of the regular staff and management, the existing management's involvement in the development of the crisis (e.g., Did anyone in management commit fraud?), and the time frame. For example, if speed is of the utmost importance, the crisis-response team could be set up to report directly to the board and not the top management and be endowed with a high level of decision-making authority.

Last but not least, as a rule, every member of a crisis-response team should have a successor, especially if there is a risk that a member is personally involved in or even liable for the development of the crisis or has a conflict of interest. Remember that the crisis-response team is only a temporary solution and must be abolished or integrated into daily operations once the crisis has been successfully managed.

3.4.6. What if there is not an effective board in place?

As mentioned before, not all boards are effective or live up to their responsibilities (a truth that is certainly not limited to emerging economies).

The reasons are manifold. For one, the board members might be too detached and not know what is going on, or not energetic enough to "learn the ropes" and assume their duties. In any case, a board that is not functioning in normal times and has not earned the respect of management and shareholders will not do so in a crisis situation. In easy times,



when the whole economy is growing rapidly and plenty of credit is available, the board's dysfunction might not show up in results for some time. But in a crisis situation this becomes dramatically clear very soon, and the implications are also clear: the company will accelerate on its way to demise, becoming bankrupt in a short time.

Unless, that is, someone steps in and takes over the functions of the board. In fact—unfortunately—there are only two options: either management assumes the powers of the board and takes the necessary decisions without regard to regulation or bylaws, or the shareholders become active and control the company via decisions made in the general meeting (or by sheer force of their personality). This second option is highly plausible when there are only a few shareholders and they have been involved in management anyhow. Crisis response by management or by individual shareholders might lead to similar results, depending on the experience of the shareholders who take the reins or the competences (and involvement in the build-up of the crisis) of management. In any case, these options involve higher risks than the situation in which the board lives up to its value-adding functions and responsibilities in a robust corporate governance system.

Shareholders might also consider changing the board, but this question should be thought through as carefully as the decision to fire management in a crisis (see “When to Fire the CEO” above). The shareholders must determine who else could take the role of the existing board members on short notice and how much time these people would need to understand the company and the situation and make better decisions.

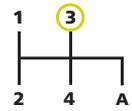
3.5.

COMMUNICATE ACTIONS AND SOLUTIONS

A crucial part of crisis management is communication during and after the crisis. Having established good relations and a communication pattern between the board and the company's stakeholders before the crisis obviously helps (so if you are reading this Handbook and are not in the midst of fighting a crisis, think about your current relations with stakeholders and whether there is a need to improve them). The problem with bad stakeholder relations in the middle of a crisis is clear: there are few foundations on which the board can build support for its actions—and making new friends in a crisis is rare.

No matter the state of relations, though, it makes sense to draw a quick “map” of them in order to understand the complexity of interrelations and interdependencies between the company and its internal and external stakeholders as well as among the different stakeholders themselves:

- Relations with management: These are usually shaped by the regular routine of board meetings, and particularly by how many executives are also board members (if this is legally allowed) or what the power structures of the board have



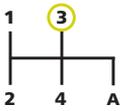
been in the past. The important question is whether the board has dominated management or vice versa. Such power relations do not change in a crisis, but instead are exaggerated. A dominant management might even ignore the board in a crisis situation completely, or a dominant board might tend to micromanage even more.

- Relations with shareholders: These are often shaped by the number of shareholders and their homogeneity (e.g., Is it a group of equals or is there a dominant shareholder with many small minority shareholders?), their representation on the board, and their previous interactions with management. The crucial questions are, Do shareholders communicate directly with management or only through the board? What is the existing decision-making pattern? How much discretion does the board have relative to the general meeting? How do crisis-management decisions affect this balance? What information from the general meetings is communicated to others, and how? In most cases it makes sense for relations with shareholders (if they are not all represented on the board) to be the responsibility of the chairman, but depending on board members' expertise and the specific tasks to be accomplished, this might be delegated to certain board members to ensure rapid and effective communication in the crisis situation.
- Relations with stakeholders: Stakeholders come in many types, from employees to banks, regulators, and of course NGOs. Some legislation contains provisions that employees be represented on the board. It is important for the board as a whole to decide whether it is helpful for these employee representatives to monopolize communications with the other employees. This direct link to the employees might be beneficial, but speaking with one voice from the board to a variety of stakeholders might also be beneficial. The right choice depends on the relations with employees, the nature of their representatives, and the crisis itself. With other stakeholders it is important to know how the board communicated with them in the past and what future communication must look like.

Whatever the answers to these individual questions are, there has to be a clear definition and allocation of responsibilities. In the end, after that allocation has been accomplished, there are three ground rules for crisis communication in this complex web of interrelations:

- Don't "oversell" and create unrealistic expectations. The dynamics of a crisis are highly uncertain and it usually takes more time and effort than planned to reverse the situation and get back to normal.
- Simplify but do not hide the brutal facts. Outside of management the details do not matter as much as the overall plausibility and credibility of the proposed solution to the crisis. Everybody knows that the company is in a crisis, so do not try to hide this fact; instead, focus on the most important actions that will make a difference.

Advice



- Communicate personally as much as possible. Remember that 80 percent of personal communication is nonverbal. Your display of confidence and competence might count more to the other side of the table than the details of the turnaround plan.

Lessons for the Road

- Don't blame others for the crisis; instead, take responsibility and action. Managing corporate crises is always difficult because of time constraints, constantly changing information, and the personal and corporate risks involved. There is too much at stake, from credibility to personal freedom, not to mention a lot of money, for you to spend your time ineffectively.
- It is the board's responsibility to bring the evidence into line and push for the appropriate measures. These measures should always be geared to the two key questions of how to survive the crisis and how to emerge stronger afterward.
- In a crisis, the board needs to change its way of working in order to make more active decisions and to support the management, depending on the type of crisis and the competence of the board. The responsibilities of the different players on the board evolve differently: for example, the chairman needs to help the company to restore credibility, the non-executive directors could help the company to overcome paralysis by providing perspective and experienced advice, the corporate secretary needs to play a greater role in organizing meetings, and the shareholders or owners might need to make more investment capital available.
- Communication in a crisis is the most difficult task, yet of the utmost importance in avoiding dishonesty (which risks credibility) and lawsuits (which risk loss of the license to operate or hefty fines). Thus, a clear line of communication should be established, with a very select group of people being allowed to give information to the public.

Mini Case Study: Best Lease in Trouble

Ted Gu was reviewing the numbers of Best Lease of Burkina, and they promised yet another bad year for the financial institution. As the acting chairman of the

board he had just overseen the release of the former chairman a month earlier, but he knew that a change of board leadership was not enough to turn the leasing company around and ensure its survival.

Over two years (2007–8) the institution had experienced a loss of €1.5 million, while its production slumped from a peak of €170.5 million in 2005 to €25.5 million in 2008.

Ted, appointed by a minority shareholder a year ago, could see a variety of reasons for this sluggish performance. “But this dramatic erosion calls for immediate action,” he thought.

Background on Best Lease of Burkina

The leasing company’s original business plan was concerned with providing leasing for local companies. Its share capital in 2009 was €3 million. But the losses had brought it down by close to 50 percent. The first years were very good for a start-up, but since 2007 things had been going wrong.

A project for the future?

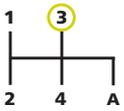
In 2007, the general manager (GM) proposed to the board his concept of a Regional Leasing Holding. This holding would enable BLB to extend its leasing activities to five subregion countries.

The shareholders and the board all agreed to the proposed changes, although the chairman of the board voiced some reservations, concerned that the expansion would be too rapid.

Deserting business

In 2008 both the production as well as the net income of BLB dropped significantly, while the rate of risks (the ratio of bad risks to total risks; bad risks have to be provisioned up to 100 percent from the profits of the company) rose to an unprecedented 16 percent.

At a quick glance, a lack of business and funding due to the economic crisis seemed to be the source of the problems, causing customers’ inability to pay their interest or repay their loans. However, upon closer inspection various other factors could be identified. The auditors—after lax analysis of the accounts over the previous years—demanded a major change in the provisions, especially regarding the appreciation of the risks. This led to a big loss in 2007. Also, the interpersonal conflict between the chairman and



the GM surfaced stronger than ever before. The chairman, a retired banker from the “old school,” often acted impulsively, which drove the GM to do everything in his power to become independent in his decisions and actions. As a result, the directors noticed too late that the business was really “going down the drain” rapidly.

Making the situation even worse were uncontrolled rumors, such as that Best Lease was going bankrupt or that the GM had been relieved of his duties.

As a consequence of these problems, the tone in the company started to worsen. This affected not only the relationship between the chairman and the GM, but also the climate in the board and the morale among staff. Indeed, four of the best-trained managers at Best Lease handed in their resignation letters because of this situation, raising further questions about the credibility and the future of the organization. On the financial side, the company faced more and more difficulties generating enough cash flow to pay salaries and expenses, not to mention its debts to various lenders. As the majority of the board thought that it was more important to keep the operational experience of the GM, the chairman was pushed out in a close vote. Ted was appointed acting chairman.

A lost investment?

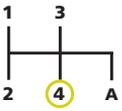
“This board meeting must bring a decisive change,” Ted thought. “Either we really stage a turnaround of this heavy crisis or all our investment will be lost. We need to work on the basics of business, as well as the team. If we do not come together, we will go under—but how?” It was clear to him that he needed to come up with a detailed proposal now!

Financial Results of BLB

(in €1,000)	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Production	1,400	1,600	2,500	3,000	4,200	5,500	7,500	5,000	5,200	2,500
Net income	-100	+6	+110	+130	+150	+350	+170	+70	-950	-550
Current risk	1,500	2,800	3,500	6,000	7,000	8,500	11,000	12,500	10,500	9,500
Rate of risk (%)	—	0.5	0.5	1	2	2.8	4	7.5	12	16
Dividends	—	—	—	—	—	180	—	—	—	—

Chapter 4

After
the Crisis



Learning from Mistakes

Luckily nobody was hurt when your daughter drove a bit too fast on an icy road with her somewhat older car. Her car was damaged but worth repairing, and after she received the repair bill, you wanted to know how she was doing.

Her answer surprised you:

“You know,” she said, “not only does my car look nicer than before—my door has no more scratches and dents—but my brakes are also working much better now that they have been replaced. And I bought winter tires. The car feels and is safer than before—I have to admit that. And on top of that, I also learned that on snow-covered roads my car definitely needs some more careful handling.”

You could only hope that the lessons your daughter learned would be permanent!

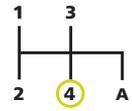
“The crisis also revealed weaknesses in our business model. The real art was to find immediate remedies which also were helpful in the longer term for the redesign of our core strategy.”—CEO, Caucasus region

4.1.

POSTACTION REVIEW: AFTER THE LAST CRISIS IS BEFORE THE NEXT ONE

This Handbook time and again has sought to argue that the real art of crisis management is to act even in the heat of the crisis in a way that is robustly right—both in the short term as well as in the long term. As soon as the worst of the crisis is over, sales are recovering, and a liquidity buffer is building up again, it is the right (and probably only) time to start a postaction review in a board meeting. The reasons for a postcrisis review are quite simple: there have always been various economic crises and there will be more in the future! Thus, the primary questions board members should ask are, Is the company, relative to its competitors, stronger than before the crisis? How can the company leverage these advantages? The board should pose these questions to itself and to the management (and perhaps also to shareholders) and look for satisfactory answers in three categories:

- What is the general lesson of the crisis?



- What is the sustainable competitive advantage now from the actions taken?
- What is the specific lesson for the work of the board?

It is probably even worthwhile to address these issues in a dedicated board meeting held off-site. Here, as in all board meetings, the atmosphere should be one of honest dialogue within the board but especially between the board and management, and, if necessary, with key shareholders. Open-mindedness, willingness to learn and improve, and not passing blame or looking for easy scapegoats remain crucial to the success of such an endeavor. Otherwise, defensiveness and hidden agendas will prevent the transformation of the crisis experience into better work by the board and management and, thus, by the company.

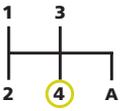
The results of the meeting—not the discussion itself—should be documented. After all, board members might need to review these points sometime sooner than expected, and they can be valuable reading for new board members.

4.2. LEARNING FROM THE CRISIS

In the process of reviewing the causes, origins, and further dynamics of the crisis as well as the responses and actions taken by the board and the management, the following questions can be raised to identify general lessons from the crisis:

Ask

- Were the causes and driving factors of the crisis on our radar screen? Have we identified these factors before and prioritized them correctly? If not, why not? Will these factors be dangerous and important to watch in the years to come?
- When did the crisis emerge and when did we recognize it (earlier or later than everybody else)? How long did it take us to respond? Were there any delays? Can the response time be shortened for future crises?
- Was the flow of information timely, relevant, and complete throughout the organization? Was the necessary and relevant information readily available (the litmus test for control)?
- Was the communication with key stakeholders (e.g., employees, banks, media) effective? Did we get our message across? Where were communication bottlenecks located?



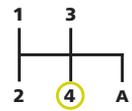
- If a crisis-response team was set up, did that choice make sense? What was the impact on the normal chain of management? Were the right internal and external people hired? Were competences, accountabilities, and reporting lines clear?
- What were the financial implications of the crisis? Should the balance sheet structure and the liquidity planning be redesigned? Was the diversification of funding appropriate?
- How did the shareholders react? Were we able to convince them of our ability to deal with the crisis? Do we need to adapt our funding options (e.g., loans)? Was the communication with shareholders appropriate? Did we listen to them properly?
- What are the implications for our risk prioritization and the related management systems? Are revisions needed?
- Was the board functioning well? Did we work together as a team? Did the non-executives and the executives have aligned interests or did we squander time and resources by squabbling?
- What are the consequences in human resources? Is our personnel apt to move the company forward, past the crisis? Do we need to adapt our human resources (hire or release people)?
- And last but not least: Have the heroes of overcoming the crisis and the partners whose cooperation was especially valuable been identified and rewarded? How can relations with these people be strengthened?

Finding answers to these questions can take a while in board discussions, and the temptation to pass blame or point fingers must be strongly resisted. Once they are found, the answers and lessons should be minuted and implemented. The crisis management lessons should be formalized into a lesson-book that can be used in future crises, so that nothing learned is lost.

4.3.

PROFITING FROM THE CRISIS

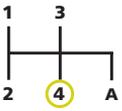
With the help of the analysis described above, the company and the board can learn from past mistakes, in order to prevent them in the future on the one hand and profit from the crisis on



the other. Some “smart moves,” backed up by empirical evidence, that can help a company profit from a crisis are listed below. The key factor is the observation that a general or industry-specific crisis often leads to a reshuffling of market positions.

Analyze

- As various studies have revealed (see Mathews 2005), companies that emerge as winners from crises invest in the future of their business countercyclically (against industry trends) in product R&D or new, cost-competitive capacity. By contrast, those companies that don’t invest—for instance, because they can’t afford any additional expenditures—are at risk of being overtaken by competitors or new market entrants. This has happened five times in the liquid crystal display (LCD) market: each time the industry went through a downturn, new players emerged as the market leaders in the next bull market. The new entrants invested heavily in new technologies during the downturn, poached key engineers from the incumbents, and were able to provide the next generation of LCDs (Mathews 2005).
- In order to be on the winning side when the market returns, it is worth looking in particular at the markets that competitors left during the crisis. There are often great opportunities to grab a position as the new leader in these markets (which is important because market share and profitability are highly correlated). Often a new distribution channel can be set up to serve specific customers; for example, in a crisis the “C-customers,” with high transaction costs and low revenues, are often no longer served appropriately, but an e-distribution channel can focus on this customer segment as a profitable growth opportunity.
- Also look at the labor market, especially for highly qualified specialists, including new graduates. They might now be easily attracted by offers that they wouldn’t even have looked at during the boom.
- Furthermore, identify opportunities for M&A. Oddly, most M&A activity happens in the last phase of a boom, when prices are high and insiders know that the good times are coming to an end. However, the real bargains can be found in a crisis (as long as the company can maintain positive cash flow at such a time).
- Last, especially after the crisis, hard work is necessary to maintain the lean organization and lower cost level that have been achieved during the crisis by restructuring. Far too often companies return to their previous “fat” level once business is recovering. This “yo-yo effect” is similar to the dieting practices of some individuals. Obviously, this bulking up should not be allowed to happen, because it is much more difficult to slim down again later, when the next crisis hits.



4.4.

EVOLUTION OF BOARD WORK

This Handbook started with the assertion that a crisis is a litmus test for the corporate governance system and the added value it provides for its organization. The experience of crises, especially if managed well, will give a further push to the work and cooperation at the helm of the company.

In addition to asking questions regarding the lessons and opportunities to profit from the crisis (as discussed in the previous two sections) and making sure that the lessons learned are not easily forgotten, the board's functioning in the crisis should also be reviewed. There are three aspects that are generally considered:

Review

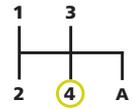
- The information flow between management and the board: Since this was probably adjusted for the crisis situation (e.g., more frequent exchanges of information, a focus on cash), it needs a readjustment after the crisis. This is also a chance to take action on the timeliness, quality, and relevance of information. Often board information systems have grown “organically” over the years (with an ever-thicker board book), and rarely does a board clearly articulate to management what kind of information priorities the board is setting to meet its working requirements. The time after a crisis is a good opportunity to review the information system (as well as other underlying processes) and set up a leaner one more specifically tailored to the board's needs.

Ask

- The interaction between board and management in decision making: Like the information flow, the “line” separating management from the board has also shifted (as discussed above, it can move in either direction) and needs readjustment. If the crisis and the new division of labor have revealed competence gaps in management or on the board, these should be dealt with after the crisis. The question is, Should the old balance be restored, or should a new division of labor, responsibilities, and accountabilities between the board and management be set up?

Review

- The priorities and focus of board work: The board should review its work priorities, as reflected in the allocation of time on its agenda. Around



the world, boards spend relatively too much time looking in the rearview mirror. A crisis reveals how important it is for the board to scan the business environment in all directions and to read the early warning signals on time. As mentioned frequently above, spotting a crisis early on is the most important precondition for successfully managing it. Therefore, a key lesson for a board is to spend more time looking forward and to take steps to reduce the probability of crises (see chapter 2.4).

In many cases the lessons of the crisis include the need to redesign the business model, as new competitors have emerged, technological shifts or changes in customer preferences have become visible, and so forth. The board and management must take turns in leading this process: based on a sober analysis by management, the board decides on the high-priority drivers of change that should shape the redesign of the business model and what the new sustainable competitive advantage should be. This requires a range of specific actions that management needs to develop, but in doing so it should use the expertise of board members (e.g., if logistics or the supply chain is an issue, a board member with experience in the auto industry could be very helpful).

But such a review—especially regarding board work—should not be done only once and in an ad hoc manner. Empirical evidence from many countries points to the fact that an annual review by the board of its own performance, its value-adding contributions, and the effectiveness of its processes is the most powerful tool for driving the evolution of corporate governance and board work (Conger, Finegold, and Lawler 1998; Graf 2007; Julien and Rieger 2003; Leblanc 2005). All this requires is the board's readiness for an open and honest debate and the belief that "good can be always done better"!

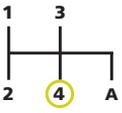
4.5.

THE PLEASURE OF SUCCESS: CORPORATE GOVERNANCE AND CRISIS MANAGEMENT

Once the company has overcome the crisis, the board can celebrate this success, as long as the following conditions are satisfied:

Look Ahead

- The board has sufficient reasons to believe—and is assured by independent outsiders—that it was on the watch, read the "writing on the wall" on time, and did not contribute directly to the crisis.



Act

- The board did its duty before and during the crisis by maintaining a high level of presence, conducting emergency meetings as needed, ensuring rapid and concise information flow and communication, using effective decision-making processes, and keeping a good balance between supporting and supervising management.

Review

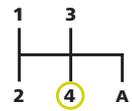
- The board has not only conducted a post-crisis review but has also enforced the necessary consequences (both on the strategic level and for the management team).

Communicate

- The board has understood and communicated that the crisis was also a test of the corporate governance system and of the individual members of the board and management and that their value has been proven, but the lessons of the crisis will lead to further evolution and upgrading of the corporate governance system (including the presence of non-executive and independent directors).

Lessons for the Road

- Run a postcrisis action review: What was done right during the crisis? What needs to be improved in crisis management?
- List the actions taken to prevent the next crisis and to improve the robustness and financial resilience of the business model.
- Run a board evaluation and look at the weak spots in the board's performance, its decision-making processes, and its information sources and biases.
- Reflect on how trust and team relations have been improved by the crisis—and if not, why not. What have you learned about the competence and character of senior executives?



Mini Case Study: Party Hard AFTER the Work Is Done

There was a certain party atmosphere in the boardroom of Pacific Chem, a fine chemical company with locations in four Asian countries, exports throughout the world, and a turnover of \$6 billion. After six wrenching quarters during the recession, there was finally a quarterly profit.

“We belong to the survivors,” the chairman gloated as he commented on the profit. All the other directors were equally appreciative and full of praise for the company management—all but George Brown. George was the only non-Asian on the board, and he couldn’t help but think that these celebrations were premature.

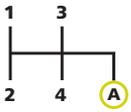
His concern centered around two major issues. The first was that in the recession, in his view, major weaknesses in Pacific Chem’s business model had become visible. Certainly, the cost cutting during the crisis had eliminated organizational waste and reduced the corporate overhead; however, too little was achieved in addressing the company’s competitive challenges, from low-cost providers on the one hand and from a restructured chemical industry in both the United States and Europe on the other. George firmly believed that a major redesign of the product portfolio and the key processes was needed to catch up with competitors, some of whom had used the crisis to restructure their own organization and portfolio, to recruit personnel during the downturn (with lower “price tags” on experienced engineers and managers), and to zoom ahead.

The second issue that was bothering George was how the board had worked during the crisis. The CEO flip-flopped between the attitudes of “leave me alone—I am busy saving the company” and “this is simply too much work for management, and the board needs to fill this role”—the latter especially when bankruptcy was looming. The board’s lack of orientation just added to the CEO’s confusion: without any crisis-response plan or guidance, it reacted spontaneously and in an ad hoc manner.

Looking around, George was sure that few of his peers were sharing his concerns, at least not to the same degree. Though he was confident that he had gained some recognition as an industry expert and strategic thinker during the management of the crisis, he wondered how hard he should press this advantage by voicing his concerns. Should he spoil the party now, or should he just relax for a moment and enjoy the celebration?

George knew the answer to these questions—this was the best and only time to learn from the crisis. The question was how he could voice his concerns so that his colleagues would listen to him now.

Appendixes



Appendix A: Glossary

Accountability: The liability of a board of directors to shareholders and stakeholders for corporate performance and actions of the corporation. It is the concept of being responsible for all actions performed by the company's management and reporting these actions to stakeholders.

Acquisition: Gaining control of another corporation by stock purchase or exchange. An acquisition can be either hostile (against the other corporation's wishes) or friendly.

Audit: An examination and verification of a company's financial and accounting records and supporting documents by a professional and independent external party.

Board of Directors: The group of individuals elected by the shareholders of a company to define the company's vision and mission, set the strategy, and oversee the management. The board is charged with selecting the chief executive officer (CEO), defining the compensation package of officers, and setting the long-term objectives of the firm.

Chairman of the Board: The highest-ranking director in a board of directors. The chairman is responsible for elaborating the board's agenda and ensuring that business is conducted in the interest of all shareholders.

Chief Executive Officer (CEO): The highest-ranking officer of the company, who reports to the board of directors. The CEO is tasked with short-term decisions, while the board of directors sets the company's long-term objectives.

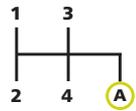
Codes of Conduct/Ethics: Guidelines developed and adopted by organizations to define the appropriate course of action in relevant and potentially delicate situations.

Committees of the Board: Groups comprising board members that are established to assist the board in the analysis of specific subjects outside of regular board meetings.

Compliance: Agreeing to and abiding by rules and regulations. In general, compliance means conforming to a specification, policy (internal or external), standard, or law that has been clearly defined.

Concentrated Ownership: A form of ownership in which a single shareholder (or a small group of shareholders, united by agreement) holds the majority of the company's voting shares.

Conflict of Interest: A situation in which a person or group has a stake in a matter of business that may be different from the interest of the organization and can influence or make decisions motivated by that bias.



Contingency Approach: A pragmatic conceptual framework that analyzes the shaping forces of a situation (personalities, interests, etc.) and the structural conditions and restrictions as the relevant drivers in decision making.

Controlling Shareholders: Shareholders who own enough of the company's voting shares—typically 30 percent or more—to control the composition of the board of directors.

Disclosure: The public dissemination of material, market-influencing information in accordance with the requirements of a regulatory authority or with self-regulatory contracts. This is one of the main principles of corporate governance.

Duty of Care: The obligation of every board member to fulfill her assignment with the care of a professional businessperson. This includes, among others, the duties to collect and process information, to participate in a professional decision-making process, and to be present at meetings.

Fiduciary Duty: The legal obligation of every board member to serve in the best interest of the company as an organization and of all shareholders.

Independent Auditors: Professionals from an external auditing firm charged with overseeing a company's financial reports. They must have no personal interest in the financial statements so that they may render an unbiased judgment about the financial position of the company.

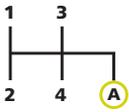
Independent Director: A member of the board whose only nontrivial professional, familial, or financial connection to the corporation, its chairman, its CEO, or any other executive officer is his directorship. For IFC's definition of an independent director, see Appendix B.

Internal Audit: An appraisal of the financial health of a company's operations by its own employees. The employees who carry out this function are called internal auditors.

Minority Shareholders: Those shareholders with minority stakes (usually less than 5 percent) in a company controlled by a majority shareholder.

Non-executive Director: On a one-tier board, a director who has no professional assignment in the company. In many legal frameworks today there are requirements about the percentage of non-executive directors on boards. In a two-tier system, by definition, all directors on the supervisory board are non-executive and all those on the management board are executives.

Nominee Director: A director who is nominated by a (significant) shareholder to represent this shareholder on the board (but who is obliged, like all directors, to always act in the best interest of the company rather than of any individual). In most jurisdictions such nominations are allowed only in unlisted companies.



OECD Principles of Corporate Governance: Corporate governance principles as defined by the Organisation for Economic Co-operation and Development.³

Ownership Structure: The distribution of shares in a company among shareholders.

Related Parties: Subsidiaries, joint-venture partners, family members, or companies owned by or affiliated with a company.

Risk Management: The process of analyzing a corporation's exposure to risk and determining optimal approaches to handling such exposure.

Shareholders: Holders of stock issued by a company.

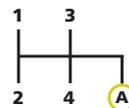
Shareholders' Rights: The rights extending from ownership of shares, categorized according to two types: voting rights and cash-flow rights.

Stakeholder: A person or organization that has a legitimate interest in a project or company, including any supplier, creditor, client, employee, or local community that is affected by the actions of the company.

Takeover: The purchase of a public company (the "target") by another company (the "acquirer" or "bidder").

Transparency: The corporate governance principle of publishing and disclosing information relevant to stakeholders' interests.

³ The 2004 revision of these principles is available for download in several languages from the OECD Web site, at http://www.oecd.org/document/49/0,3343,en_2649_34813_31530865_1_1_1_1,00.html.

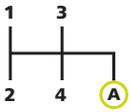


Appendix B: IFC's Indicative Independent Director Definition

The purpose of identifying and appointing independent directors is to ensure that the board includes directors who can effectively exercise their best judgment for the exclusive benefit of the Company, judgment that is not clouded by real or perceived conflicts of interest. IFC expects that in each case where a director is identified as “independent” the board of directors will affirmatively determine that such director meets the requirements established by the board and is otherwise free of material relations with the Company’s management, controllers, or others that might reasonably be expected to interfere with the independent exercise of his/her best judgment for the exclusive interest of the Company. An indicative definition follows. In each case, the Company and IFC should consider changes tailored to those sorts of relationships that would impair a director’s independence, taking into account the circumstances of the particular Company.

“Independent Director” means a Director who has no direct or indirect, material relationship with the Company other than membership on the Board and who:

- a. is not, and has not been in the past five (5) years, employed by the Company or its Affiliates;
- b. does not have, and has not had in the past five (5) years, a business relationship with the Company or its Affiliates (either directly or as a partner, shareholder (other than to the extent to which shares are held by such director pursuant to a requirement of Applicable Law in the Country relating to directors generally), director, officer or senior employee of a Person that has or had such a relationship);
- c. is not affiliated with any non-profit organization that receives significant funding from the Company or its Affiliates;
- d. does not receive and has not received any additional remuneration from the Company or its Affiliates other than his director’s fee and such director’s fee does not constitute a significant portion of his annual income;
- e. does not participate in any share option [scheme]/[plan] or pension [scheme]/[plan] of the Company or any of its Affiliates;
- f. is not employed as an executive officer of another company where any of the Company’s executives serve on that company’s board of directors;
- g. is not, nor has been at any time during the past five (5) years, affiliated with or employed by a present or former auditor of the Company or any of its Affiliates;

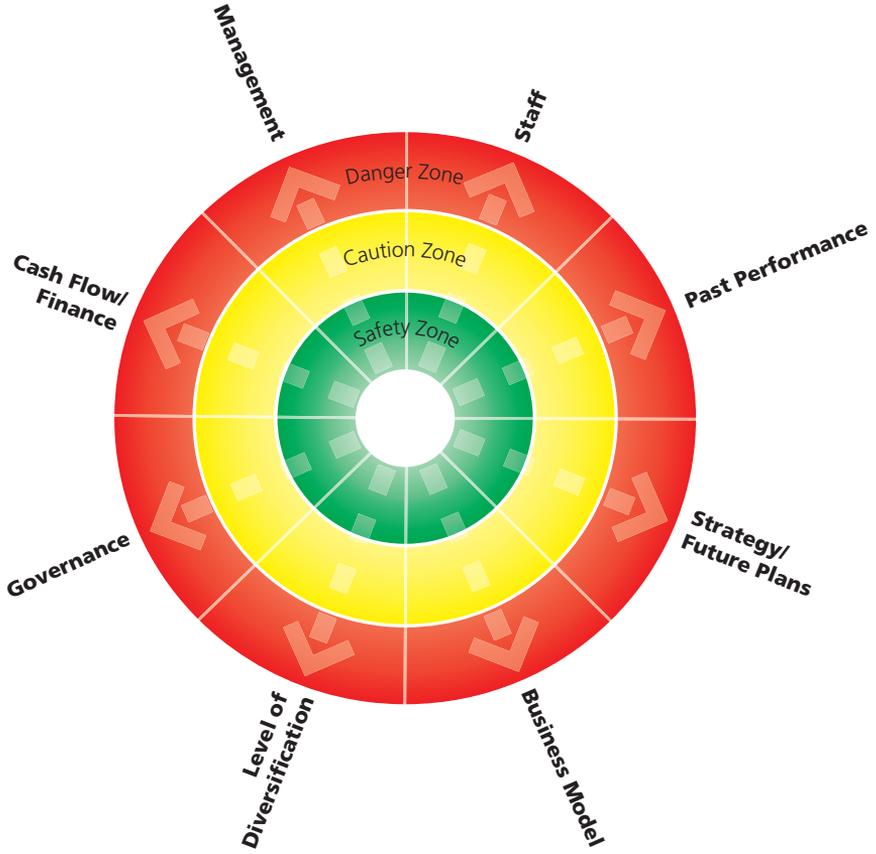


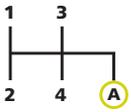
- h. does not hold a material interest in the Company or its Affiliates (either directly or as a partner, shareholder, director, officer or senior employee of a person that holds such an interest);
- i. is not a member of the immediate family (and is not the executor, administrator or personal representative of any such Person who is deceased or legally incompetent) of any individual who would not meet any of the tests set out in (a) to (i) above (were he a director of the Company); and
- j. has not served on the Board for more than [ten (10)] years.

For purposes of this definition “material interest” shall mean a direct or indirect ownership of voting shares representing at least [two percent (2%)] of the outstanding voting power or equity of the Company or any of its Affiliates.

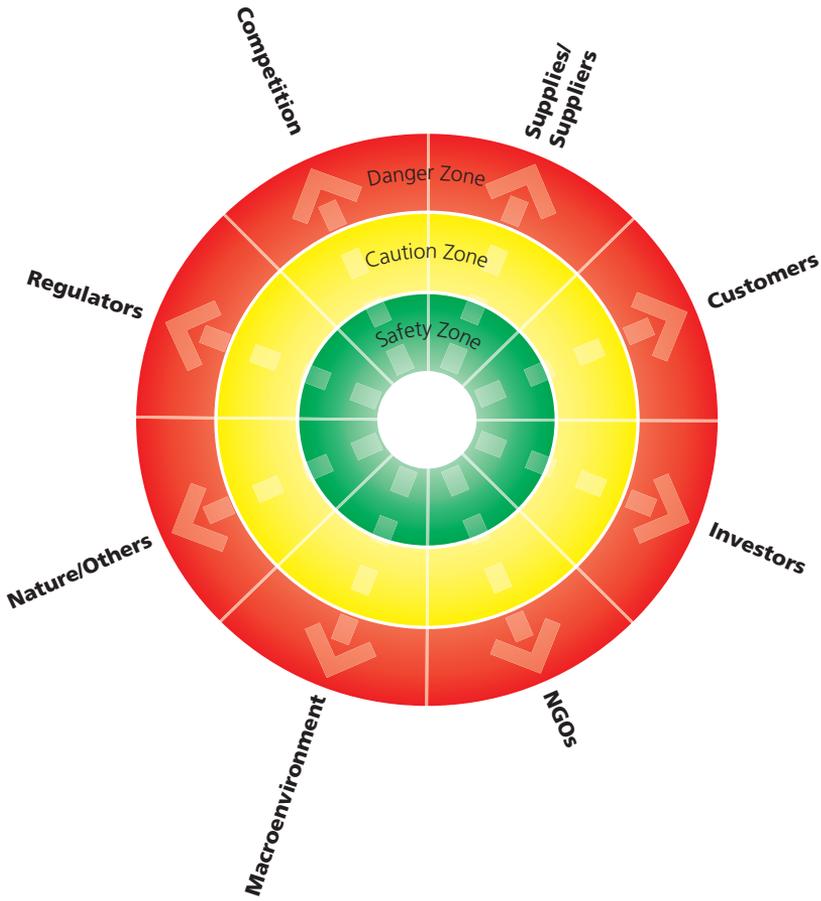
Appendix C: Risk Radar Tools

Internal Risk Radar





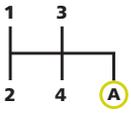
External Risk Radar



Examples of Relationships among Different Types of Risks

Financial Risks

Is affected by (input interdependency)	Financial risks	Has effects on (output interdependency)	Details/personal comments	Grade (1:safety, 2:caution, 3:danger)
commodity prices business model staff processes e.g.,	Operational risks e.g., costs of operations	cost investor confidence e.g.,		
customers clients industry cycles systemic risks e.g.,	Demand risks e.g., revenue from sales	revenues investor confidence e.g.,		
politics terrorism demand industry cycles e.g.,	Commodity risks e.g., cost of commodities	operations price of goods produced e.g.,		
politics expectations e.g.,	Exchange rate risks e.g., cost of foreign currencies	demand commodity prices e.g.,		
stock markets business strategy exchange rates e.g.,	Investment portfolio risks e.g., stockholding of company	leverage e.g.,		
politics expectations e.g.,	Systemic risks e.g., breakdown of financial sector	All e.g.,		
management decisions interest rates e.g.,	Leverage/interest risks e.g., change of interest rates	future investment opportunities e.g.,		
investor structure e.g.,	Investor/owner risks e.g., claims by investors	operations investment opportunities leverage e.g.,		

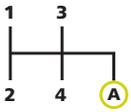


Internal Risks

Is affected by (input interdependency)	Internal risks	Has effects on (output interdependency)	Details/personal comments	Grade (1:safety, 2:caution, 3:danger)
e.g., past performance external environment	Cash flow/finance e.g., leverage, interest rates, demand risks, operational risks	e.g., strategy		
e.g., past performance	Management e.g., overconfidence, biases, capabilities	e.g., strategy cash flow		
e.g., management past performance business model	Staff e.g., capabilities, motivation, strikes	e.g., strategy HR policies		
e.g., strategy cash flow	Past performance e.g., previous strategy, level of diversification, cash flow	e.g., strategy level of diversification		
e.g., past performance management	Strategy e.g., investment strategy, future roadmap	e.g., cash flow staff diversification market access		
e.g., politics expectations	Business model e.g., staff, governance, diversification, strategy	e.g., staff governance diversification		
e.g., business model past performance	Level of diversification e.g., industries, markets, customers	e.g., strategy staff financial risks exchange rate risks		
e.g., business model past performance laws	Governance e.g., information systems, reporting systems	e.g., strategy cash flow accountability transparency		

External Risks

Is affected by (input interdependency)	External risks	Has effects on (output interdependency)	Details/personal comments	Grade (1:safety, 2:caution, 3:danger)
e.g., social trends, past performance	Regulators/politics e.g., new regulations, laws, legal requirements	operations, finance, strategy, governance e.g.,		
e.g., past performance, investors, regulators	Competition e.g., new products, technologies, poaching of customers or employees	supplier base, customers, staff, cost, revenues e.g.,		
e.g., investors, regulators, past performance	Suppliers/suppliers e.g., material/commodity availability, breaking of supply chain, quality issues	operations, strategy, costs e.g.,		
e.g., past performance, regulators, NGOs	Customers e.g., loss of customer, delay of payments	diversification, revenues, strategy e.g.,		
e.g., strategy, past performance, regulators, NGOs, management	Investors e.g., loss of confidence, withdrawal of funds	diversification, revenues, strategy e.g.,		
e.g., regulators, strategy, past performance	Media/NGOs e.g., allegations, rumors, lawsuits, seizures	operations, investor confidence e.g.,		
e.g., regulators, politics, population	Macroenvironment e.g., commodity prices, social trends, terrorism	e.g., All		
e.g., past performance	Nature/others e.g., storms, floods, fires, terrorism	operations, regulators e.g.,		



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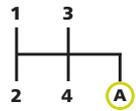
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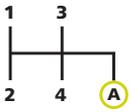
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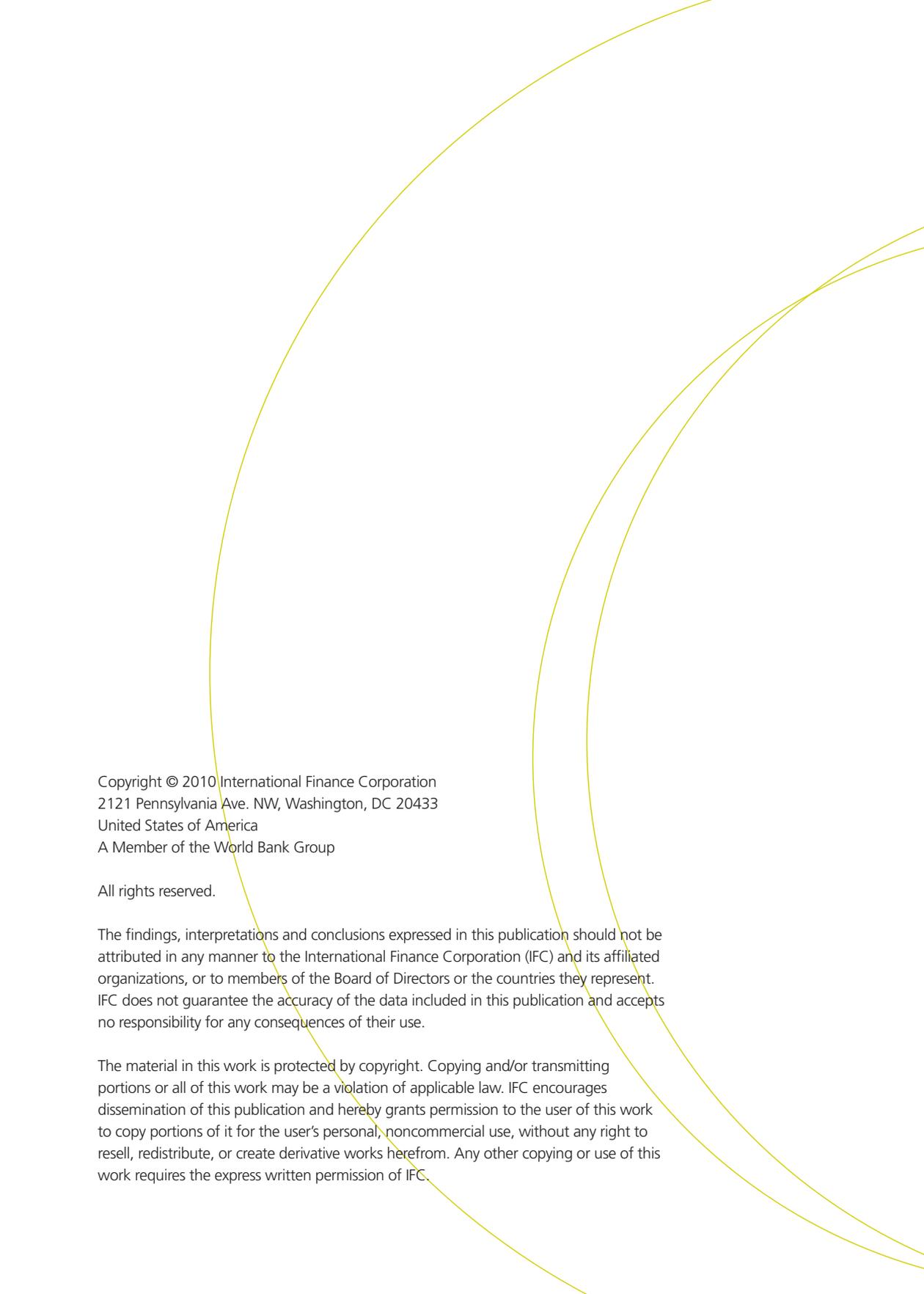
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Professor Ulrich Steger worked for the top business school IMD, leading the research and educational programs in the disciplines of corporate governance, sustainability management and complexity management. Since joining IMD, Professor Steger had directed various top management programs, including the Board Program. He has published extensively on all three subjects. Since 2005 alone, he has co-authored nine books on these topics, including *Managing Complexity in Organizations* (2010) (together with Dr. Christoph Nedopil and Wolfgang Amann), *Corporate Governance--How to Add Value* (2008) and *Sustainability Partnerships: The Manager's Handbook* (2009), as well as publications and cases in the developing world. His books have been published in German, English, Russian, Japanese and Chinese and his articles have been translated into more than ten languages. For IFC, Prof. Steger has conducted board seminars in over 10 countries in the past 16 months. He has himself served on numerous boards of directors for almost 30 years, both on the management side (e.g. Volkswagen) and the supervisory side.



Doctor Christoph Nedopil was a research associate at IMD and a consultant for the World Bank for more than three years and has been engaged in academic and business research, as well as in the development and delivery of numerous executive education programs, with a focus on corporate governance and complexity management. During his tenure at IMD, he researched extensively on the topic of corporate governance in emerging economies, he wrote more than 40 case studies and has worked on this topic with numerous companies and institutions around the globe, such as IFC, FMO, Malaysian Directors Academy, Daimler, Holcim and WWF. His publications have been translated into a number of languages, including Russian and Chinese. Since 2009, Dr. Nedopil is executive director and partner at the award winning innovation consultancy YOUSE, supporting companies to accelerate and improve their innovations.

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