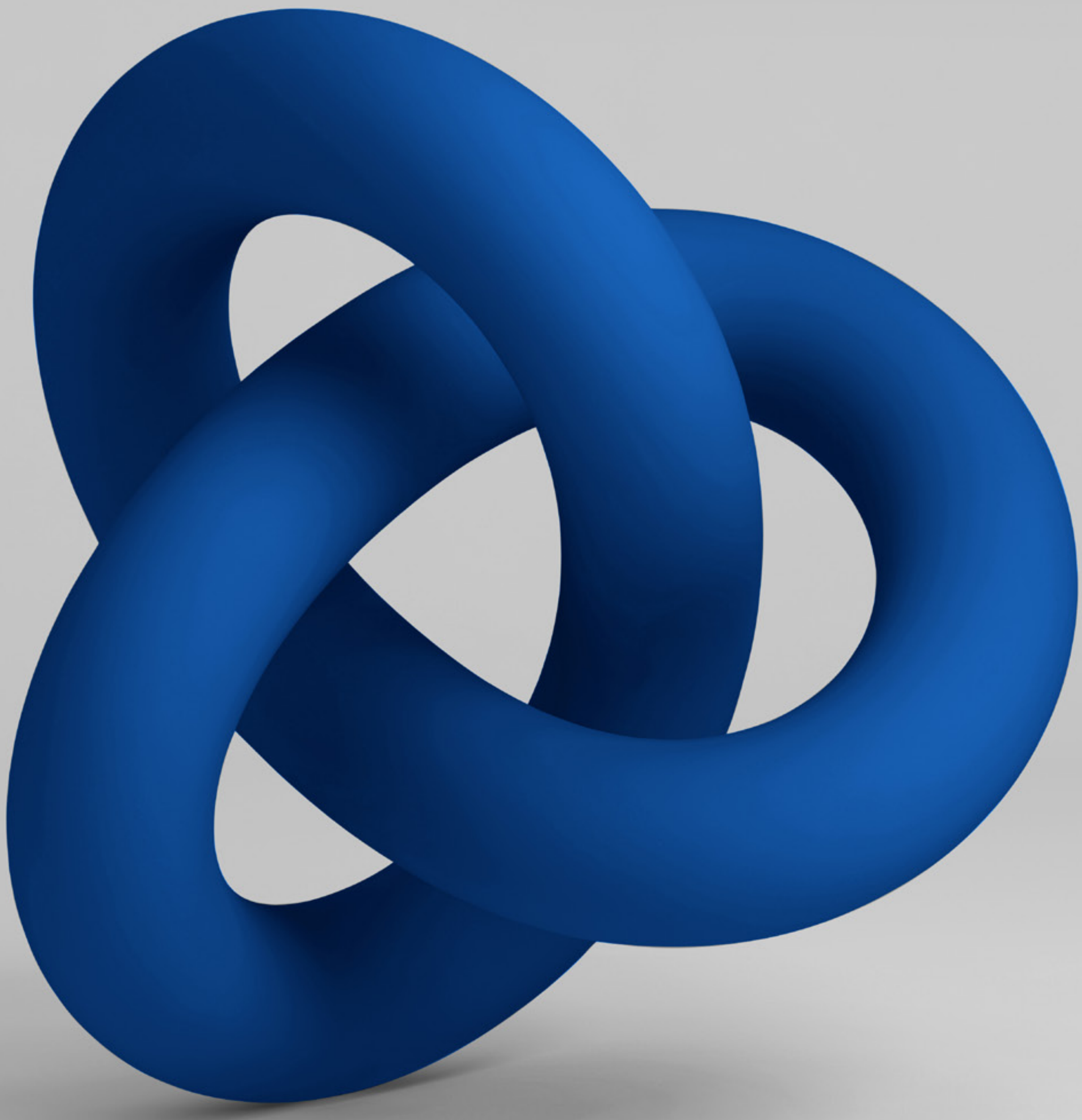
Baker McKenzie.



Trust Continuum

COVID-19: Practical considerations for Boards - VUCA times with an additional C

What does COVID-19 mean for boards?

Companies, governments and society at large are living through unprecedented times. Few predicted that a flu-like pathogen would go on to have such far-reaching effects on the world economy. Few Audit and Risk Committees will have considered including in their corporate risk registers a plan around what to expect and do in the case of a pandemic, let alone what impact it may have on the core business of the company and its future prospects. Yet here we are, watching a pandemic-induced global crisis unfolding around us and touching almost every aspect of our work, family and social lives.

As the crisis spreads and deepens, companies are being forced to react quickly to address two, intertwined, emergencies - first, dealing with the direct impact of the pandemic on the health of employees and the third parties the company deals with, and second, trying to hedge the business against the impact of the economic shocks rippling through each corner of the world. And for global companies it will feel like the challenges arrive in waves like a tsunami, as the pandemic sweeps through the different regions and countries in which they operate or have customers and suppliers.

It is clear that we are in the ‘new normal'; even beyond this pandemic, there will be continued levels of external uncertainty and volatility due to the evolution of globalization, climate and social tensions, the combined force of which requires Boards to adopt new mind-sets, protocols and behaviours to ensure corporate resilience and sustainability.

How should boards be orienting and acting in this 'new normal'? Although dealing with the immediate operational impact of all these externalities is the job of management, in our view the board's oversight role has never been as critical as it is now. The Chair should be in regular contact with the CEO, and the CEO should be keeping the board appraised of actions being taken to steer the company through these challenging times. As management will be focused principally on liquidity and immediate business concerns, boards should be closely involved in supporting management's key decisions with the aim of protecting value (or at least avoiding extreme value destruction) as well as ensuring stakeholder governance is at the heart of all decision making. The decisions made by companies at this time around employees, customers, suppliers and the communities in which they operate will not only have short term implications, but could also define society's views of those companies (and maybe the corporate world at large) in the medium and long term. Ill-thought decisions now, even if they mitigate the immediate crises as they arise, may have an adverse impact in the long term and potentially be "eroders" of trust. The board needs to keep the long term viability of the company constantly in its sights - the company will be defined in the months and years to come by the way it reacts today (and indeed every day of the crisis).

Director duties

Management will likely be addressing issues from at least three perspectives - operational, financial and reputational. The board needs to overlay this with its oversight role and support management around key decisions. Closer interaction with management at this time will mean that the information gap is narrowed and board decision making can be more effective.

Now more than ever, directors need to think carefully about their legal responsibilities as members of the board. Good corporate governance is all about understanding roles, responsibilities and accountability across the company; it is also about good decision making. In the UK boards will need to be mindful of their fiduciary duties, the key one being the so-called *section 172* (of the Companies Act 2006) duty. And for financially distressed companies, boards will need to ensure that they have a clear and regular insight into the financial health of the company to ensure they are comfortable that it continues to meet relevant solvency tests; or otherwise that they fully understand the impact of an insolvent position[1]...

To fulfil the section 172 duty, a director must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of shareholders as a whole and in doing so, have regard to a number of broader matters, which are listed in the section. By way of recap these are[2/3]: -

(a) the likely consequences of any decision in the long term;

(b) the interests of the company's employees;

(c) the need to foster the company's business relationships with suppliers, customers

and others;

(d) the impact of the company's operations on the community and the environment;

(e) the desirability of the company maintaining a reputation for high standards of

business conduct; and

(f) the need to act fairly between members of the company.

For large privately held companies with a US parent that has signed up to the Business Roundtable Statement on Corporate Purpose[4] published last year, these considerations, in particular the commitment to a broader group of stakeholders, will now resonate group-wide and not only in the UK.

Directors need to ensure that, even as they are called on to make emergency decisions in the context of a fast-moving global crisis, these factors are considered and weighed as part of a rigorous effort to maintain high quality decision-making with a view to the preservation of *long-term* value.

"During these unprecedented times, those companies that treat their customers and employees with generosity and kindness will stand out, as will those who redirect resources to help the State's efforts to combat the crisis. In my view, this pandemic will to a large extent re-set the parameters of companies' licences to operate - and those leaders who see this and make enlightened decisions will be more likely to survive the crisis and thrive in the post COVID-19 world and gain trust for the companies they lead. Such decisions will be enlightened if they adequately balance the interests of all stakeholders, that is, shareholders, employees, customers, suppliers and the communities they operate in."

Beatriz Araujo

Duty to act with care, skill and diligence

In the UK, directors also have a duty to act with the care, skill and diligence that would be exercised by a reasonably diligent person with both (i) the general knowledge, skill and experience to be expected of a director and (ii) the general knowledge, skill and experience that the director has. The standard is often referred to as that of the "reasonable director" and a director will be assumed to have the knowledge, skill and experience to be expected of a director in that role. In addition, a director with additional or more specialised knowledge (such as financial, technology or human resources qualifications or experience) will be held to the standard of a reasonable director with that knowledge.

It should be noted that there is no specific "business judgement rule" built into the UK's statutory duty of care, as there is in the US[5]. However, in the UK reference to "good faith" allows directors the freedom to exercise commercial judgment without being subject to second-guessing by the courts. The court will apply the reasonable director standard and will be more likely to be persuaded that a decision is taken in good faith if it is a decision a reasonable and intelligent director could have concluded would promote the success of company in the long-term. The courts expect boards to maintain sufficient knowledge and understanding of the company's business to enable then to discharge their duties. This implies that directors should have ready access to information regarding risks and opportunities for the company and, although they can delegate authority to deal with particular risks, they should put in place and be satisfied with systems allowing them to have oversight over any authorities they have delegated.

Judges will not apply hindsight in assessing directors' compliance with their duty to act with care, skill and diligence; directors are not expected to know the future. In the current crisis, perhaps more than ever, decisions will necessarily be taken on the basis of imperfect and daily-changing information. Missteps may be inevitable, and indecision and inaction may be the most dangerous course of all. But what is important is for boards to show that they are maintaining a robust framework for reasonable decision-making in the circumstances, and to respond to the situation as it continues to develop.

Boards must keep front of mind that trust in the company – from its shareholder(s), workforce, commercial partners, consumers and the community at large – may be won or lost on the basis of decisions taken now. Not only, perhaps not even, *what* is decided, but the basis on which decisions are made at this time of social emergency. Those boards that are clearly considering the needs of all stakeholders and their wider societal responsibility, with a laser focus on what makes their particular business resilient, will be better positioned to protect long-term value.

"Given the speed and scale of this crisis – unimaginable to most of us just weeks ago – boards are being asked to make critical decisions quickly and on the basis of a shifting fact pattern and deep uncertainty about what the next few months may bring. But, whilst boards do need to be nimble and decisive, this is not the time to neglect director duties or the principles of good governance. The usual processes for compiling board packs and convening meetings will need to be accelerated and adapted, but it is more important than ever for directors to ensure that there is clarity around roles and responsibilities, and that decisions they are taking now are based on a proper consideration of the impact on all stakeholders - with the ultimate focus being the preservation of long-term value."

Jo Hewitt

Some practical considerations for boards -

1.1 Boards should make sure that they continue to have a clear and detailed picture from management as to the company's financial situation - external commitments, ability to draw cash from borrowings, in particular regular updates on the company's viability in the short, medium and long term.

1.2 Boards must understand the approach being taken by management vis-à-vis employees and workers in its aim to ensure that jobs are as far as possible protected and the long-term contribution of the workforce to the company is secured. How regularly is the management team communicating with the workforce, and is the tone of such communications in line with the company's aspired culture? At this time it will be crucial for the board to consider both the direct and indirect impact of any key decisions on the workforce.

1.3 Boards must ask what strategies is management following as regards engagement with customers and suppliers - for example, calling on force majeure provisions in contractual relationships; flexing payment terms and delivery schedules. Most companies will be both customer and supplier in this regard and should look to adopt consistent strategies, while keeping an eye on the importance of these relationships and the sustainability of the supply chain on the long term prospects of the company.

1.4 Boards must challenge management to consider whether and how any of the company's resources may be re-deployed or used to help in the fight against COVID-19.

1.5 From a corporate governance perspective and to maintain effective decision making in the interests of the company, its workforce and other business partners, Boards are encouraged by the Financial Reporting Council (FRC) to, amongst other things:

(a) develop and implement mitigating actions and processes to ensure that they continue to operate an effective control environment: in particular, addressing any key reporting and other controls on which they have placed reliance historically, but which may not prove effective in the current environment; and

(b) consider how they will secure reliable and relevant information, on a continuing basis, in order to manage their future operations and those of their workforce and suppliers, including the flow of financial information from significant subsidiary, joint venture and associate group entities.[6]

1.6 Boards must pay also particular attention to capital maintenance rules and good practice around dividends, ensuring not only that sufficient reserves are available when the dividend is made but also that it is appropriate to return funds to shareholder(s) given the likely future needs of the company.

1.7 Boards, and those supporting them, should think about how the background to the decisions taken now – including the information provided to directors and the considerations weighed – are recorded for future reference; noting that the company will need to report in the next financial reporting cycle on the way in which the directors fulfilled their s172 duty during this financial year, with a particular focus on 'principal decisions'[7]. All decisions taken by boards in the current crisis that have a significant impact on the workforce, customers/suppliers, the environment or the wider community in which their business operate are likely to be deemed as 'principal decisions'.

Some practical considerations for boards -

1.8 Throughout the crisis, boards must engage with shareholders and keep them appraised of key measures being taken, both in terms of managing the risks of the crisis as well as identifying any opportunities that may be presented in the post-COVID-19 landscape. It is crucial at this time to keep shareholders on side and confident that the company is addressing the situation sensibly. The FRC has published a useful infographic on the areas investors are seeking disclosures on from listed companies, which also acts as a useful checklist for unlisted boards[8]:

Reporting during times of uncertainty

Five current questions investors seek information on...				
Resources		**Action**		**The future**
1 **How much cash does the company have?**	**2** **What cash and liquidity could the company obtain in the short-term?**	**3** **What can the company do to manage expenditure in the short-term?**	**4** **What other actions can the company take to ensure its viability?**	**5** **How is the company protecting its key assets and value drivers?**
Helpful disclosure might include: · The amount and nature of cash and liquid resources. · Where the cash is located within the group (legal entities, countries, currencies etc). · Whether there are any barriers to accessing the cash (capital controls, regulatory issues). · Whether there is an impact from accessing the cash, such as tax or other liabilities.	Helpful disclosure might include: · Information about the company's short-term financing arrangements, facilities and other obligations and likely changes. · Information about the credit lines (committed and uncommitted, drawn and undrawn) the company has access to. · Whether the company has additional support e.g. from related businesses, shareholders, suppliers. · Whether there are any covenants that are being imposed or waived.	Helpful disclosure might include: · Whether the company is changing its dividend policy or cancelling a dividend. · Information on the extent to which supplier financing schemes are being used, and what commitment the provider has given to maintain access to these schemes. · Information about the nature and timing of capital expenditure commitments, and whether there is any flexibility. · Information about any payments that may be deferred e.g. tax payments. · Information about the company's approach to its pension funding.	Helpful disclosure might include: · Information of the nature of any government-backed support, by country and any conditions that attach to this. · Information about any stress testing/reverse testing carried out and how the viability of different parts of the group are being affected. · Whether there are any intergroup guarantees and commitments. · Details of how the board is monitoring the situation.	Helpful disclosure might include: · Plausible scenarios on revenue and costs over the short-term and into a longer transition period. · Details of the likely impact of shorter-term decisions on the company's key assets and longer-term drivers of value, e.g. people, brands, licences. · Approach to support employees. · Information about how the company is managing commitments with customers where services are delayed. · Information about how the company might adapt its business model and strategy in the short/medium term.

For key insights and materials to help you understand, prepare and respond quickly to the significant challenges posed by COVID-19, visit our global **Coronavirus Resource Center**

Sources

[1] A description of the rules around insolvency for UK companies and their directors is beyond the scope of this article; but it should be noted that on 28 March 2020 the UK Government announced that the provisions of the insolvency regime relating to 'wrongful trading' would be temporarily suspended in the COVID-19 crisis, reportedly to protect directors who decide that the company should continue to pay staff and creditors notwithstanding the solvency risk.

[2] Publication of the Wates Corporate Governance

[3] GC100 Guidance

[4] BRT Statement on the Purpose of a Corporation

[5] In the US, the board is called to fulfil its oversight role to the best of its ability. Directors will have the protection of the business judgment rule where they act on an informed basis, in good faith, and in the honest belief that their decisions are in the company's best interests.

[6] FRC Guidance issued 27/03/20

[7] Financial Reporting Council's Guidance on the Strategic Report

[8] www.frc.org.uk

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