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Insights for boards and audit committees

Building a better working world

In this issue

This edition of the BoardMatters Quarterly is focused on the Indian company law, provisions on the governance of subsidiaries and the responsibilities of the board of directors in this context. The Insolvency and Bankruptcy Code (IBC), 2016 too provisions for punitive liabilities for directors. This issue highlights some of the key action areas for directors to minimize these risks. The final chapter of this issue addresses corporate crisis response and the board's role in confronting them.

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Never has a legal policy phase been more historic

An era of accountability of boards of directors in corporate groups is upon us

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The next frontier of corporate governance jurisprudence in India will be in the field of governance at the level of the group to which a company belongs. While the first steps in intervention were taken in the newly minted company law in 2013, with related party transactions being regulated *(although in a light-touch manner)*, there is a lot more than related party transactions that is at play.

Conducting business as a group is a social reality in corporate India. Examples and structures abound – broadly, may be summarized in the following categories:

- Listed companies conducting businesses through subsidiaries that are not listed;
- Listed companies holding majority stake in listed subsidiaries;
- Listed companies being controlled by an unlisted company, which may or may not be a "holding company" (holding as they may, less than majority equity ownership);
- Listed companies that are not majority-owned by any person, in turn, hold a non-majority stake in the other listed companies.

Each of these categories presents corporate governance challenges that have not been specifically thought about in the law. It can never be the expectation of the law that it should think about every possibility. Yet, given the nature of the social construct of corporate India, regulation of these constructs is surprisingly thin. As a result, a generally feudal mindset of a company "belonging to" the promoter abounds and it is in that mindset that diametrically opposite directions have to be taken in the evolution of company law jurisprudence.

When there is more than one company in a chain of companies, one fundamental issue emerges. Are the affairs of a company also the affairs of the company that is either its holding company or its promoter, is the question that often arises. When the balance sheet of a company derives value from the balance sheet of another company, investors and stakeholders of the company would obviously expect (and would be reasonable to expect) the company to be mindful of the operations of the companies below.

How the company in question uses its powers over the companies below, and what efforts it takes to ensure that the companies below conduct themselves appropriately will occupy litigation in the next few decades.

General law of torts gives a clear guidance on the question. Let's say a company engaged in handling hazardous substances blunders in safety standards. The company that controls it – the holding company or the company that is the promoter exercising control, would be answerable. It cannot be said that there is a limited liability in the conduct of the affairs of a company and the companies above have no role or say in the violations or negligence or reckless conduct by a subsidiary. As the law is evolving, the examination of whether a company that was in control conducted itself well enough towards ensuring that there is no malfunctioning by the companies below is increasingly being brought into question.

Regulatory and statutory interventions are codifying this general law of torts into explicit law. For example, the Insolvency and Bankruptcy Code, 2016 was amended to explicitly bring in Section 29A to disqualify any entity that is "connected" to a company that is a non-performing asset or was in control over a company that has defaulted and has gone insolvent, from seeking to resolve any other insolvent company. This is a classic example of how the corporate veil is being lifted by statute to bring in implications and consequences for members of a group and related parties [1].

Yet, it can never be argued that a subsidiary has to take instructions from the holding company or the controlling promoter.

Every board of directors of every company, including those of every layer of subsidiary companies, is obligated by law to attend to the best interests of all stakeholders of that company.

In balancing interests, the board of directors of a company may have to take a position that the interests of a company are best served by a decision that need not necessarily be palatable to, or convenient to the holding company or the promoter. The director on the board of directors is obliged to act, bearing only the interests of the stakeholders of the company whose board she sits on.

It is another matter that if the holding company or the promoter dislikes the fact that you do not toe the line, it can sack you. Even independent directors under law do not have a tenure protection from being appointed and sacked at the pleasure of the majority. Yet, if a holding company or a promoter is majoritarian in inflicting its views on how the affairs of the company must be run, it is the board of directors that is a check and balance on the majoritarian promoter. It is quite akin to the ruling on Brexit by the Supreme Court of the United Kingdom[2]. In a nutshell, just as Parliament is the body charged by constitutional law to decide, the will of the majority of the people may guide Parliament but the representatives chosen by the people have the duty to decide. Therefore, the shareholders may appoint the board of directors, but the directors cannot say that since the shareholders have given an instruction, they no longer have to apply their minds to what ought to be done in the best interests of the company.

The role of independent directors is even more vital in this interplay of balancing the best interests of a controlling shareholder and the interests of the company itself. While every director is responsible and dutybound to act in the best interests of the company under Section 166 of the Companies Act, 2013, Section 149 and Schedule IV of the law impose special obligations on the independent directors to be mindful of minorities' interests and to address the interests of stakeholders.

One must remember that jurisdiction to conduct class action suits has now been conferred on the National Company Law Tribunal. The accountability of those in control of a company can actually now be enforced in monetary terms by seeking damages. Names and sizes of the promoter and controlling company is no deterrence to accountability being sought. When a forum has been made available, litigation will eventually follow. As case law develops – some of it horribly adverse and some of it amazingly laudable – codification of judicial decisions will follow. In this journey where the pages of history are being turned, boards of directors are faced with an opportunity – of either creating history, or of being referred to in history, not necessarily in laudable terms. Never has the time been more apt for directors to step up vigilance over every decision they consider.

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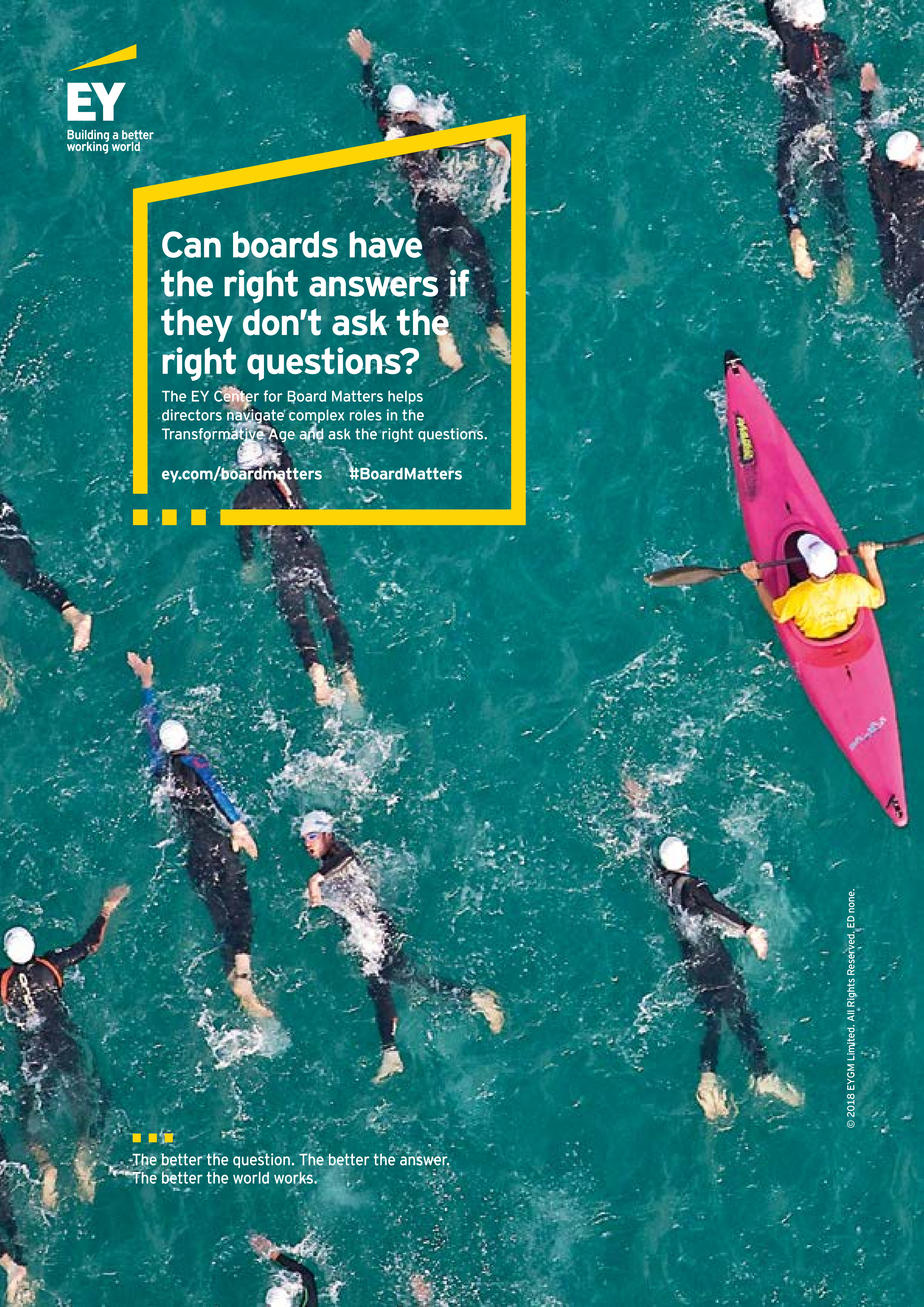
[1] For a detailed analysis of how the corporate veil is lifted in the Insolvency and Bankruptcy Code, 2016, please see the decision of the Supreme Court of India in the case of ArcelorMittal India Private Limited vs. Satish Kumar Gupta & Ors. A full text is available here: https://ibbi.gov.in/webadmin/pdf/order/2018/Oct/33945_2018_Judgement_04-Oct-2018_2018-10-04%2015:36:20.pdf

[2]An official summary can be read here: https://www.judiciary.uk/wp-content/uploads/2016/11/summary-r-miller-v-secretary-of-state-for-exiting-the-eu-20161103.pdf while the full judgement is available here: https://www.judiciary.uk/wp-content/uploads/2016/11/r-miller-v-secretary-of-state-for-exiting-eu-amended-20161122.pdf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Subsidiary companies and the governance conundrum

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Changes to the regulations around corporate governance in India and globally has been a subject of substantial discussion. The speed and magnitude of change has been unprecedented and it re-emphasizes the need to introspect on the key elements of corporate governance, including the role of all stakeholders. Regulations can only drive as much change, and their true impact will be felt only once these changes are implemented in spirit rather than text.

The recent Kotak Committee report on corporate governance emphasized the significance of an appropriate level of review and oversight by the board of a listed entity over its unlisted subsidiaries to protect the interest of shareholders. This article discusses the responsibilities of directors of a parent company on the affairs of its subsidiary companies.

Before delving more into this aspect, let's take a quick look at some of the existing regulations and key recommendations of the Kotak Committee report.

Existing regulations

- At least one independent director on the board of directors of the listed entity shall be a director on the board of directors of an unlisted material subsidiary, incorporated in India.
- The audit committee of the listed entity shall also review the financial statements, in particular, the investments made by the unlisted subsidiary.
- The minutes of the meetings of the board of directors of the unlisted subsidiary shall be placed at the meeting of the board of directors of the listed entity.
- The management of the unlisted subsidiary shall periodically bring to the notice of the board of directors of the listed entity, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary.
- A listed entity shall not dispose of shares in its material subsidiary resulting in reduction of its shareholding (either on its own or together with other subsidiaries) to less than 50% or cease the exercise of control over the subsidiary without passing a special resolution in its general meeting except in cases where such divestment is made under a scheme of arrangement duly approved by a court/tribunal.

- Selling, disposing and leasing of assets amounting to more than 20% of the assets of the material subsidiary on an aggregate basis during a financial year shall require a prior approval of shareholders by way of a special resolution, unless the sale/disposal/lease is made under a scheme of arrangement duly approved by a court/tribunal.
- Where a listed entity has a listed subsidiary, which is itself a holding company, the provisions of this regulation shall apply to the listed subsidiary as far as its subsidiaries are concerned.

Proposed and adopted recommendations of the Kotak Committee

- Threshold for classifying a subsidiary as a material subsidiary revised from 20% to 10% (percentage of income or net worth of subsidiary to consolidated income or net worth).
- Foreign subsidiary is included in the definition of material subsidiary for the purpose of appointing an independent director on the board of the subsidiary from the board of the holding company. However, the threshold for classifying foreign subsidiary as material subsidiary is maintained at 20%.
- Significant transactions of an unlisted subsidiary are to be brought to the notice of the board of the listed entity irrespective of whether it's a material subsidiary or not.
- Audit committee of the listed entity shall monitor the utilization of loans/advances/investments by the holding company exceeding INR 100 crores or 10% of subsidiary's asset size, whichever is lower.
- On the Internal Financial Controls (IFC) reporting requirements, the committee recommended that IFC be made applicable to the entire operations of the group and not just to the Indian operations.
- In case of a listed entity with many unlisted subsidiaries:
  - The listed entity may monitor their governance through a dedicated group governance unit or a governance committee comprising the members of the board of the listed entity.
  - A strong and effective group governance policy may be established by the entity.
  - The decision of setting up such a unit/committee and having such a group governance policy may be left to the board of the listed entity.

The committee suggested no amendments to the Securities and Exchange Board of India (SEBI) Listing Obligations and Disclosure Requirements (LODR) regulations. However, guidance may be issued by SEBI stating the above requirements where a listed entity has multiple unlisted subsidiaries.

Key considerations for governance over subsidiary companies

The responsibilities of directors of the listed entity for governance over its subsidiaries.

Directors' responsibilities with respect to listed entities are defined under the Companies Act 2013 and LODR, which also includes IFC, risk management compliance, etc. However, without explicit responsibilities defined for directors to have an oversight over subsidiaries, can directors be expected to effectively execute this responsibility mandated under the Companies Act 2013 or SEBI regulations? Recent incidents of governance failures have also indicated, how transactions are routed through subsidiaries which are not in line with the governance principles.

Regulations for directors to monitor effectiveness of subsidiary governance.

The regulations provide comprehensive requirements for listed entities. However, these requirements do not apply entirely to unlisted subsidiaries. Does it mean that regulations do not require directors to exercise the same level of oversight over the subsidiary as for the listed entity? It is advisable that directors excersise the same level of oversight over subsidiaries.

Implicaton for the board and directors of listed entities.

Though some of the Kotak Committee recommendations are not currently adopted as regulations, the importance of these recommendations cannot be undermined. In the current scenario of globalization, the operations of companies are spread across different geographies, and companies adopt business models wherein subsidiary companies operate in line with overall strategy of the group. Therefore, it is imperative for directors of listed entities to have an effective oversight and review of the operations of subsidiaries. Some of the key areas for oversight of subsidiaries by directors of listed entities may include:

- Effectiveness of risk management systems
- Effectiveness of internal financial controls
- Effectiveness of compliance management systems
- Nature of transactions with other subsidiaries
- Other related party transactions and significant transactions of subsidiaries
- Effectiveness of financial management system and reporting processes

Implications for the management of unlisted subsidiaries.

The management of subsidiaries should devise a mechanism to provide periodic updates and information to the board of listed entities on the following:

- Significant transactions or arrangements
- Utilization of funds (loan, advances or investments by listed entities)
- Other information with respect to risk management, IFC, compliance management, etc. as desired by the board of a listed entity

The approach is to reach at the right balance of oversight and control to be exercised by the board of the listed parent entity over its subsidiaries.

The key considerations for effective oversight over a subsidiary are:

- Representation of a listed entity on the board of a subsidiary: The regulation clearly defines that at least one independent director of the listed entity should be a director on the board of a subsidiary. Companies should consider the skillsets or competence requirements given the expectations from the independent director who is appointed to the board of the subsidiary.
- Effectiveness of review of a subsidiary performed by the board of a listed company: Significant transactions, minutes of board meeting, financial statements, etc. of all the unlisted subsidiaries need to be reviewed by the board of the parent, irrespective of the materiality of the subsidiary. The board should assess if both the time spent on the review of transactions of the subsidiary and the manner of review are adequate.
- Delegation of authority: Identify critical transactions where subsidiaries need to obtain approval of the parent listed company and formalize a charter of authority to govern such decisions.

- Geographic disparities in which subsidiary operates: Effectiveness of risk management considering the political, legal, tax and other aspects unique to the geography and business operations of the subsidiary.
- Entity-level policies to be cascaded down to subsidiaries: Uniformity of entity-level policies can enable and drive effectiveness of governance across subsidiaries.
- Effectiveness of financial reporting process: Review key accounting policies, effectiveness of financial reporting systems and significant accounting estimates and judgements.

It would be fair to state that the parent entity board does have a responsibility towards the operations of its subsidiaries, especially the unlisted ones. It is recommended, therefore, to devise a mechanism and/or policy stating the governance the entity intends to exercise over its subsidiaries. While the policy needs to capture all the aspects mandated under the statues, the focus must be on the level of risk emanating from these subsidiaries to the parent entity, and accordingly defining an oversight mechanism. The key principle is to ensure the right balance of decision-making authority and appropriate level of oversight without impairing the ability of the subsidiary to operate as an independent entity.

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Directors' liabilities in the new insolvency regime

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Directors have fiduciary duties under section 166 of the Companies Act 2013. Key highlights of which are:

> *A director is to act in good faith; exercise his duties with due and reasonable care, skill and diligence; and not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates.*

Corporate financial stress is not new to India Inc. and the landmark Insolvency and Bankruptcy Code (IBC) of 2016 has set the country on a positive direction with respect to stressed asset resolution. Directors must manage their fiduciary duties in periods of corporate stress, when several competing factors are likely to exist. The implications of misconduct and complacency could be severe.

Liability of directors under the Insolvency and Bankruptcy Code

Experts have analyzed and critiqued several important features of the IBC. However, an aspect which has received little attention is the new liability regime introduced for directors of companies which enter a corporate insolvency resolution process (CIRP) under the IBC.

The IBC introduces the concept of 'wrongful trading'. IBC to a large extent codifies the regime against directors for actions such as defrauding creditors, asset stripping, and falsification of books of accounts of the company. Though the imposition of fines and imprisonment raises concerns, it is the interpretation of the new disgorgement based liability which could cause greater risk to directors.

The IBC considered the legislative best practices from advanced insolvency jurisdictions the world over. The wrongful trading provision has been borrowed from the UK Insolvency Act, 1986 (the 'UK Act'). Criminal liability for directors for defrauding creditors existed in the UK even prior to the UK Act. However, it was felt that a new standard should be introduced to afford compensation based remedy to those creditors who suffered a loss due to the mismanagement of the company in the zone of insolvency – even if such a mismanagement by the directors of the company fell short of the level of criminality. In this article we allude several times to the UK Act and how the Indian IBC has evolved.

Wrongful trading

The relevant section of the IBC operates to make directors personally liable to contribute towards the company's debts where they have continued trading beyond the point where they knew or ought to have known that the company had no reasonable prospect of avoiding going into insolvent liquidation. As per the provisions of section 66(2) of the IBC, a director is liable to make contributions to the assets of the company and the National Company Law Tribunal ('NCLT') may restore such amounts from a director's personal assets, if two conditions are satisfied: (i) he knew or ought to have known that there was no reasonable prospect of avoiding the commencement of a CIRP against the company; and (ii) he did not exercise due diligence in minimizing the potential loss to the creditors of the company.

A director is said to have exercised sufficient due diligence if such diligence was reasonably expected of a person carrying out the same functions as the director.

Scope for liability of directors

Introducing wrongful trading under the IBC should afford significant protection to creditors dealing with distressed companies. However, directors must be aware of the surrounding liability issues.

The threshold for incurring directors' liability

Under the UK Act, the wrongful trading section only applies when the directors should have known that there was no reasonable prospect of avoiding an insolvent liquidation of the company. Section 66(2) of the Indian IBC applies when there was no reasonable prospect of avoiding the commencement of a CIRP against the company. Note that under the IBC, a CIRP may be commenced on a mere payment default of INR 100,000.

There is sound logic for advancing or moving forward of the trigger point from an insolvent liquidation (i.e. the UK standard) to the commencement of CIRP (i.e. the IBC standard). It is to incentivize directors to take mitigating action at the first onset of any financial distress rather than waiting in saving the company as a going concern when it is no longer commercially tenable. At the same time, advancing the threshold at which directors need to take corrective action increases the prospect of personal liability.

Mitigation of potential liability: Meeting NCLT's subjective satisfaction

Given this standard, what are the steps that directors can take to mitigate potential losses to creditors? Section 66 (2) of the IBC creates a safe-harbor for directors' actions taken to mitigate losses with sufficient due diligence, for example, by seeking advice from an appropriate qualified professional. The NCLT will decide if the mitigating actions taken by the director meets the standards expected of a person carrying out the same functions as are carried out by such directors. There is a broad spectrum of actions a director may take to mitigate creditors' losses. However, the directors' liability will depend on the subjective assessment of the NCLT as to whether his actions meet the "due diligence" standard. As a result, directors may not know *a priori* if their actions will meet the scrutiny of the judiciary.

Safe choice vs. correct choice: Dilemma for directors

The UK case law considers several actions on the part of the directors as being reasonable and prudent to meet the due diligence test. The takeaway appears to be that voluntarily filing for an administration procedure under the UK Act is certainly a safe and legally tenable course of action. Drawing an analogy, in the absence of judicial precedents or any further guidance from the IBC, a safe option for directors facing an imminent payment default by a company also could be to voluntarily file for CIRP. Consequently section 66 (2) of the IBC will put directors in the position of making a difficult choice between (i) applying for the commencement of a CIRP process against the company and thereby avoiding personal liability; or (ii) making a genuine and good faith attempt to remedy the default and continue trading.

Directors fearing a wrongful trading liability, may act in a risk averse manner and could be tempted to file for a CIRP prematurely instead of endeavoring to weather the temporary financial difficulty and try to preserve long-term value. This causes a real threat of unnecessary commencement of CIRPs against fundamentally sound businesses causing disruption to consumers, suppliers and employees.

Means of mitigating liability of directors

Directors need to maintain a fine balance in preserving value in a sound business on one hand and avoiding personal liability on the other. It is not an easy situation, especially for companies which are clearly solvent but could potentially be dragged into a CIRP owing to temporary liquidity issues.

In the absence of any clarity on how the concept of wrongful trading will play out in Indian courts, the directors could consider the following steps to be able to maintain this balance:

- Negotiate all debt contracts and material supply contracts such that any payment default will entitle the counterparty to initiate a CIRP only after affording the company an adequately long notice period to consider all viable options. This will help directors buy time to consider their options carefully.
- Put in place the processes of consultation with the company's auditors to ensure availability of adequate and timely financial information about the company.
- Regularly hold board meetings to discuss and review the cash flows of the company and closely monitor all actual and contingent claims against the company.
- Review the director and officer insurance policies (D&O Insurance) to ensure that they cover any liability arising as a result of wrongful trading.
- Obtain professional advice and document that the mitigating steps taken at the onset of a potential CIRP will meet the test of "due diligence" under the section 66 (2) of the IBC.

Responsibility of directors in case of widespread corporate structures

It is a settled position that the board of directors of a company have a fiduciary responsibility to act in the interest of the stakeholders, which amongst other would include the subsidiaries. The board of a holding company will have a fiduciary duty to take decision for the benefit of the subsidiary and in certain situations the board of the holding company can be held accountable for the act of the subsidiary company.

What directors can do?

- Take proactive steps to understand the impact of any distress in the group;
- Call an extra-ordinary board meeting, to discuss the matter and where appropriate professional advice can be sought; and
- Commit to a course of action to the benefit of the company and all stakeholders in the context of the situation faced.

The aforesaid has been observed by the Supreme Court when it noted that:

If a company is a parent company, that company's executive director(s) should lead the group and the company's shareholder's influence will generally be employed to that end. This obviously implies a restriction on the autonomy of the subsidiary's executive directors. Such a restriction, which is the inevitable consequences of any group structure, is generally accepted, both in corporate and tax laws.

The court further noted that,

Where the subsidiary's executive directors' competences are transferred to other persons/ bodies or where the subsidiary's executive directors' decision making has become fully subordinate to the holding company with the consequence that the subsidiary's executive directors are no more than puppets then the turning point in respect of the subsidiary's place of residence comes about.

In the matter of Chitra Sharma & Ors. v. Union of India & Ors, during proceedings of corporate insolvency resolution process for the subsidiary company, the Supreme Court, directed the holding company, to deposit a sum of INR 2,000 crores to be potentially used in the resolution of the insolvency of the subsidiary. The Supreme Court also restrained the eight independent directors and five promoter directors of the holding company from alienating their personal properties or assets in any manner, failing which they would not only be liable for criminal prosecution but also contempt of the court. Additionally, the court also directed that the properties and assets of their immediate and dependent family members should not be transferred in any manner.

The IBC has radically altered the insolvency landscape in India and should go a long way in resolving distressed situations, enhancing recoveries for all stakeholders and reducing the scope for misfeasance by directors and promoters. However, mandating directors to take creditor focused action at an early onset of financial difficulty could create pitfalls for professional managers and directors who may not have any fraudulent or criminal intent. Till such time, as the law becomes settled, directors are advised to take all possible steps to eliminate personal liability without compromising the prospects of commercially viable businesses.

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The board's role in confronting crisis

A corporate crisis in today's world accelerates more quickly with a larger impact than ever before. The 24-hour news cycle and prevalence of social media contribute to the risk of destabilization.

A crisis can be the result of several different types of incidents and developments and take on many forms. For example:

- Reports or even hints of executive misconduct or a toxic work culture can ignite a media firestorm.
- Negative and misleading videos and comments can go viral and damage reputations.
- The polarization of people, governmental policies and politicians can catch companies unaware and put them in highly public debates.
- Executing business-model initiatives and certain compensation incentive strategies can result in unintended consequences and enterprise-wide risk.
- Natural and man-made disasters throw tightly linked supply chains into imbalance, amplifying how a regional event can have significantly greater and more far-reaching impacts.
- A single cyber breach can have devastating consequences.

These incidents may call into question the effectiveness of a company's board of directors and its ability to provide an effective oversight and governance. While prevention must always remain a priority, advance crisis preparation is now imperative as avoiding crises entirely is nearly impossible.

To help companies prepare for the challenge, boards should determine that management has a practical and relevant crisis response program and can actively oversee and challenge all aspects of that program, including key considerations before, during and after an event. This includes determining that management has the right framework in place and that it has sustainable capabilities to allow the company to react to and quickly recover from crisis events. In preparing for and especially when confronting a crisis, boards should also understand the roles and potential implications to key stakeholders. Boards should also participate in various simulations and tabletop exercises with management teams to enhance their effectiveness in responding to crises.

Overseeing management's crisis response program

A corporate crisis can impact organizational culture, business operations and reputation — all of which can have significant financial, legal and regulatory ramifications.

Therefore, a crisis management program should bring together a variety of stakeholders who can understand the potential implications and help plan for and recover from a crisis.

The program should be managed by someone with an in-depth legal and compliance experience, who is able to manage day-to-day operational and tactical responses. It should also closely align the internal and external communications leaders to make sure that the decisions and messaging are clearly and directly articulated to the key audiences.

The crisis management program should be a process within the company's broader resiliency toolkit and integrated into its enterprise risk management (ERM) program. This integration helps safeguard that crisis response planning is aligned with and informed by the company's strategic plan and risk tolerances, and that it is dynamic and evolves along with changes to risk assessments and prioritization. Most importantly, a robust ERM program is foundational for risk management, litigation prevention and loss mitigation.

Crisis components and considerations

Types and causes of a crisis

- Corporate scandals or fraud
- Employee and/or executive misconduct
- Corporate governance breakdowns
- Product failures or recalls
- Cyber-related events and breaches
- External market events
- Geopolitical developments
- Environmental events or natural disasters
- Negative social media coverage
- Poor corporate culture
- Workplace violence
- Unintended consequences of business model execution

Potential actions to take

- Continuously communicate throughout the crisis
- Investigate to determine:
  - How and what occurred?
  - When did the company first know about it?
  - Who else knows about it? Who should know about it?
  - Is management implicated?
  - Were laws, regulations or corporate policies violated?
  - What aspects of the company's operations have been disrupted?
  - Who was responsible?
  - Which properties or technologies were affected?
  - Is there any information that the company is waiting for?
  - Has the media covered this or a similar issue?
  - How is the situation likely to change?
- Perform forensic activities, as needed
- Assess damage and severity of the crisis
- Contain, remediate, eradicate and communicate
- Monitor (internal and media outlets, including social media)

Key stakeholders to consider and involve

- Internal stakeholders
  - The board
  - In-house counsel
  - Compliance/risk management
  - Internal audit
  - Investor relations
  - Human resources
  - Finance
  - Information security
  - Corporate security
  - Public relations
  - Impacted business lines
  - Employees
  - Company governance affairs
- External stakeholders
  - Law enforcement agencies
  - Policymakers and regulators
  - Outside counsel
  - Third-party experts (e.g., accounting and media consultants)
  - Insurance companies
  - Banks and lenders
  - Debtholders and shareholders
  - Vendors and suppliers
  - Customers
  - Media
  - Market analysts
  - Local community

Stakeholders involved in crisis response

As the linchpin of the company's response, the crisis response program must involve key constituencies and integrate their knowledge and expertise in managing and recovering from the crisis. The crisis response team should work closely with impacted business-unit leaders in executing upon disaster recovery and/or business continuity plans. The key roles in the company's response may include:

- **Chief executive officer (CEO):** The CEO should be involved with leading the crisis management efforts, including activating the management team and appropriate resources to gather information and work swiftly to determine the appropriate steps to mitigate the effects of the crisis.
- **Business operations and impacted business units:** The chief operating officer (or equivalent executive of the impacted business unit) should focus on obtaining an understanding of the enterprise-wide impact the crisis had on operations (including customers, suppliers and any other impacted parties), as well as executing upon disaster recovery and business continuity plans. The business operations team should make sure operations are adequately supported during the crisis and strive to revert to "business as usual" as quickly and efficiently as possible.
- **In-house and external counsel:** In-house counsel is integral to nearly all response activities and needs to be equipped with as much information as possible to determine potential compliance and legal impacts and interface effectively with various parties, including external counsel, which also plays a critical role throughout the entire response. In advance of a crisis, in-house counsel should verify that initial briefings and any statements made to the press via talking points and scripts are developed for crisis events (including considerations regarding potential liabilities, material omissions or misstatements). In addition to the message, companies also need to make sure the lines of approval are clear and determine who the messenger will be. The internal counsel should also verify that agreements and/or retainers are in place for critical external parties (including direct and easy access to mobile numbers of third parties).
- **Chief communications officer (CCO) or equivalent:** The CCO is integral toward establishing trust by sharing credible and transparent messaging that defines what has occurred, the impact and how the organization is seeking to stabilize, learn and improve from the crisis. The CCO will also oversee the monitoring of any feedback or new developments on social media or elsewhere. They act as the conduit for taking the decisions made and turning them into reactive or proactive messaging and actions. Depending on the severity of the issue, an external crisis communications team may also be engaged.
- **Chief risk officer (CRO):** The CRO should work closely with in-house counsel(s) to proactively identify and manage any risks that may arise as a result of the crisis or the crisis response plan (e.g., compliance and safety).
- **Chief financial officer (CFO):** Depending on the financial impact, the CFO will work closely with in-house counsel(s) to file any required public disclosures relating to the event and will also play a key role in coordinating with in-house counsel(s) in filing insurance claims and other related required protocols. The CFO is also integral in working with business units to assess the impact of the crisis (e.g., financial and liquidity considerations, operational and functional impacts, implications to the investor community), and quickly working with other members of the executive team on possible responses.
- **External auditor:** The auditor needs to understand and evaluate any potential adverse financial impacts of the crisis (including regulatory, legal and internal control implications) and make sure that the related financial effects and appropriate disclosures are accurately reflected in financial statements.
- **Technology, information systems and security teams:** Depending on the nature of the crisis event, key systems, supporting technologies and data may not be accessible and/or compromised. If the crisis has a cyber dimension, the chief information officer, chief security officer and/or chief technology officer are at the heart of the operational response. These individuals may need to work with other business functions to determine alternatives to key processes to support affected stakeholders (customers, employees, etc.) and possibly implement backup processes (such as manual workarounds) during the crisis.

- **Investor relations, corporate governance and public relations:** These functions will play a pivotal role in assessing the implications of the crisis to the investor community and developing an appropriate communications strategy.
- **External investigators, public relations, marketing and human resources:** These functions may have key roles to play in evidence gathering, identification and discovery, as well as internal and external communications.

Questions for the board to consider

Q Has the company developed a crisis management "playbook" with decision process flows and escalation protocols? Do all the participants know their roles and the critical approval processes that are in place to be certain of quick and straightforward approvals?

Q Has the company considered and challenged itself on the types of crises it may face, where and how likely such events might be?

Q Has the company identified the individuals who will lead communications during a crisis?

Q Has the company identified the external advisors in the various scenarios that the company plans on seeking counsel from? If so, are agreements in place with the external advisors such that they can be mobilized quickly? Does the company have a place or virtual room secured to gather in the event of a crisis?

Q How often do senior leaders take part in tabletop exercises using realistic crisis scenarios? What role does the board play in these?

Q Does the company's response planning prioritize communications with key stakeholders, including employees, customers, shareholders and business partners?

Q If a crisis were to unfold today, how prepared is the company to react with precision, speed and confidence?

Key goals of an effective crisis response program

Board oversight considerations before an event

- The board should set the tone at the top for the importance of crisis management. A robust crisis response program may be considered a low priority, and time and money may not be appropriately allocated to crisis planning, response rehearsal and remediation efforts. The board can help address this challenge and elevate the importance of preparedness and crisis readiness.
- Depending on the nature of the crisis, boards may need to have a spokesperson to speak on behalf of the board and/or the company. The board should identify a spokesperson for the board (ideally an independent board leader) who will be prepared to represent the company and the board, as needed, and will serve as the key point of contact for management during the event.
- The board should feel comfortable with the crisis response plan, including how the board will be getting information throughout the crisis, and how should the board actively oversee its development and testing.
- The board should have a deep understanding of the company's strategy, culture, disclosure protocols, ERM process and external business developments. This knowledge enables the board to challenge management's biases, help identify warning signs that could portend a crisis and provide that the company's strategic objectives and values drive crisis planning and response. Leading boards may also consider engaging a third party or having an external assessment performed on the effectiveness of the crisis response plan and highlight any significant gaps.
- The board should have a good understanding of the insurance policies held by the company, including criteria for reimbursement of claims, criteria that would trigger insurance coverage to be void, what would be covered and to what extent.
- The board should verify that there is a robust feedback and monitoring system in place to assess how events are unfolding in real time to make sure the decisions are in sync with the events on the ground.

Board oversight considerations during an event

- The board must understand the scope of the crisis and its existing and potential impact to determine the scope of the board's involvement (including whether a special ad hoc committee or a designated counsel for the board is warranted) and to oversee and help guide the response strategy. This strategy should include communicating with various stakeholders, including employees, customers, the public, shareholders, external third parties and, potentially, regulators as well as law enforcement agencies.
- The board should receive regular briefings from management with the latest findings, regulator and law enforcement inquiries, vendor and supplier impacts, customer sentiment, employee reactions, litigation filings, insurance considerations, media coverage (traditional and social media) and reactions of major shareholders. In case the management is implicated and an external provider and/or investigator is retained to conduct an investigation, the board (or appropriate committee) should closely oversee the process. The board should also receive any related briefings directly from the third party.
- The board (and/or appropriate committee) should be supportive while providing an effective independent oversight as they interact with the executive management team and other key stakeholders.
- The board can help provide that the company's crisis response is consistent with its core values and purpose. New risks and unintended consequences may arise from the crisis and boards should work with management to proactively oversee the dynamic situation. The way an organization responds to a crisis can speak to, and is a test of, the organization's culture and processes. Once a response team is activated, an effective crisis management plan is the one that leads with values and communicates openly, with humility, and swiftly with the key stakeholders involved (consumers, investors, media, regulators, etc.).

Board oversight considerations after an event

- The board should assess the adequacy of management's response to the crisis and its post-crisis evaluation, recovery and corrective actions. The most effective crisis response systems are those that institute a continuous feedback loop that allows organizations to better identify risks before crisis arises to lower the probability of the occurrence of a crisis and improve its response should one arise.
- The board should evaluate its own role in responding to the crisis, including whether the board had the adequate skills, structure and information needed to enable quick, decisive and informed action. A crisis is likely to draw investor scrutiny of the company's compliance and governance, including board and committee leadership as well as director qualifications. Among other things, this scrutiny could lead to requests for engagement, shareholder proposal submissions, public campaigns opposing specific directors and interest from activist hedge funds. Proactive self-assessment by the board, direct engagement with key shareholders and transparent communications around remediation efforts and board-level changes may help address investors' concerns.

The detailed article is available on the EY Centre for BoardMatters at: ey.com/in/boardmatters

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