conversations on leadership

More Than Filling Empty Seats

A Guide to Board Composition for Energy Companies Emerging from Bankruptcy

By Steve Goodman and Trent Aulbaugh

The energy boom that ran for much of the first half of the decade generated both record revenues and ready access to capital that was often collateralized with oil marked at $90 or more per barrel. But the collapse of oil prices and the broader energy downturn has pushed hundreds of companies up against debt covenant restrictions and into subsequent bankruptcy. Indeed, from the beginning of 2015 through mid-2016, energy companies across the value chain have entered Chapter 11, with more at risk to follow as the downturn continues.

When bankruptcy or restructuring occurs, existing equity holders are often replaced with pre-petition secured, and potentially unsecured, debtholders and creditors. As part of the restructuring plan allowing the company to emerge from Chapter 11, these new equity owners often must appoint a new non-executive chairman and board of directors. But selecting a new board is not merely a box to check on the way to approval by a bankruptcy judge: How well the board oversees and advises the CEO during the vulnerable post-bankruptcy period substantially affects the company's chances of surviving, and ultimately thriving, once again.

The board faces several challenges to successfully fulfilling its mandate—starting with its formation. At financially sound companies, directors are typically replaced one or two at a time, so that new directors join a group with established governance, culture and strategic direction. Furthermore, those new directors are vetted by a nominating committee that represents shareholders that are frequently aligned with management—or at least not opposed them.

The quality of the new board will substantially affect the ability of the company to thrive once again.

The board of a company coming out of bankruptcy, however, is created under more adverse conditions. Directors in a company emerging from bankruptcy are vetted by creditors—not by a nominating committee, as is the traditional process. Candidates must be approved by a board search committee composed of the largest new equity owners and select members of the creditors committee. This new slate of directors must be disclosed prior to the confirmation hearing for the plan of reorganization and affirmed by the bankruptcy court—a process that can raise tensions with management or at least signal a fundamental change in the company's strategic direction.

Because the board of a post-bankruptcy company is usually formed from scratch rather than appointed one or two directors at a time, its members do not have the benefit of having worked together and developed a collective decision-making style. Nonetheless, the new board must from day one be able to tackle a seemingly endless set of complex problems while finding the right balance between being too hands-on and not staying close enough to the details. To complicate the boardroom atmosphere even further, in many instances the board will find that management has also been replaced—heightening the sensitivity to boardroom-management dynamics.

This array of competing agendas and areas of focus creates a complex working environment and increases the risk involved in achieving a successful turnaround. However, there are four concrete steps the post-Chapter 11 board can take that will put it on solid ground. The following guidelines are based on our work with energy boards operating in a variety of environments.

Leverage draft winds, don't fly into them

The company, its creditors and the director candidates themselves each have different priorities regarding the process of nominating and approving a post-Chapter 11 board. Understanding those distinct priorities helps provide a path to common ground and thus the faster formation of a board supported by all parties.

The company, which is now in the role of debtor, is likely to favor "nameplate" directors whose endorsement will send a strong internal and external message that the enterprise is not only poised for recovery but that there is a high likelihood of success. While nameplates have value to creditors, those creditors will be less concerned with optics than having hands-on board members with the industry and turnaround expertise necessary to provide proactive, experienced oversight of the management team.

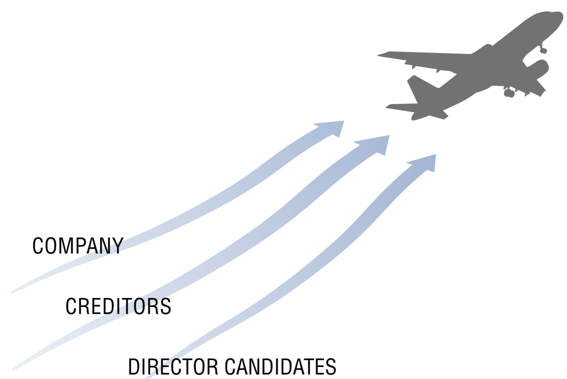
But there are differences among creditors. Secured lenders may want a prompt sale of the business or a spinoff of assets to ensure that their exposure is repaid. For them, financially astute directors with significant turnaround and exit strategy experience can be attractive. Unsecured creditors, on the other hand, may seek a longer post-Chapter 11 period to improve the business and execute strategy before realizing on their investment, working on the assumption that the value of the business will increase over time and maximize the distributions unsecured creditors receive. As a result, they may place a premium on directors with operational and strategic skills.

And then there are the director candidates themselves. Today, even financially sound companies may find it a challenge to recruit top-tier executives to a directorship, given the workload and risks that are inherent in a corporate environment rife with litigation and shareholder activism. Companies in bankruptcy setting out to recruit a board will face even greater wariness. Potential directors will want to be confident that the strategy, processes and financial structure outlined in the reorganization plan are viable, with particular attention paid to deleveraging, liquidity and access to capital. They will assess the quality of management, its buy-in with the new strategic plan and the strategy for attracting key investors.

Prospective directors also will want to understand the expected board composition and will view the exit strategy for investors represented on the board as a proxy for commitment to the company's turnaround. And there will be reputational concerns, particularly if the path to bankruptcy involved delisting or other high-profile events covered by the business media. In general, larger companies with more established profiles will have an easier time recruiting directors than smaller ones will.

Needless to say, solid D&O insurance is a must, and while it will not be brought up in early conversations, compensation is likely to play a more important role here than it would in a financially sound company. Post-reorganization board work is often intensive and relentless, and represents a significant commitment of the director's time and energy.

Understanding the perspectives of all three constituencies from the beginning allows you to turn headwinds into tailwinds.



Retaining members of the previous management and board can be a sensitive issue. Some in the industry feel that there has not been enough "house cleaning" in the recent spate of bankruptcies; others argue that it is important to separate out an executive's abilities and judgement from macro-level market conditions beyond anyone's control. In any event, director candidates will want to know the rationale behind retentions and departures and be assured of management's capability going forward.

It is critical for any energy company compiling a board emerging from Chapter 11 to remember that the demand for highly qualified directors far exceeds supply. As a result, director candidates are "in the driver's seat" and their concerns must be thoroughly addressed. Sensitivity upfront to the concerns of all three constituencies will allow the search committee to avoid flying into headwinds and instead to recognize and utilize the different objectives as tailwinds to more quickly assemble the right board.

Play moneyball

The burden of having to name the entire board at once does have a silver lining: the opportunity to create, from a clean slate, a board specifically tailored to the company's needs. For the directors of a company emerging from bankruptcy, their number one task is help steer the company to a stable future and avoid the pitfalls of the past—or worse, falling into a "Chapter 22." To fulfill this task, the board must have the clear-eyed objectivity necessary to oversee management's short-term plan and to make difficult decisions about the CEO, disbursement of underperforming assets and the achievement of milestones. At the same time, the board needs to ensure that innovation is fostered so that once short-term objectives are met, the company will have developed a competitive advantage that enables it to grow and thrive. (This topic will be addressed more fully in a separate article.) To accomplish this balance of the short- and mid-term goals, directors of a post-Chapter 11 company must be prepared to invest significantly more time for the level of hands-on involvement that the situation requires.

But judgment and commitment are not enough. Board members also must have the relevant experience and technical knowledge to make informed decisions about the company's business. Much of the energy industry is defined by technical nuance and operational efficiency on the one hand and capital flow and risk management on the other. Indeed, energy restructurings often include significant commodity risk that can lead to volatility in post-reorganization revenue and cash flow, making it even more difficult for the board and management to realize growth plans, access capital markets and increase new stock values. At exploration and production firms and at exposed midstream companies in particular, creditors will place a premium on directors with expertise in risk management and hedging and on building strong audit and risk management committees.

With these items dominating the agenda and a pace that leaves little time for moving through the learning curve, there is scant opportunity for generalists to make a meaningful contribution. The expertise of individual directors should overlap enough that multiple points of view can

The right temperament for the post-Chapter 11 boardroom

These four qualities will determine how well directors handle the stress and uncertainty inherent in a post-Chapter 11 boardroom.

Curiosity: A penchant for seeking out new experiences, knowledge and candid feedback, and an openness to learning and change

Insight: The ability to gather and make sense of information that suggests new possibilities

Engagement: A knack for using emotion and logic for communicating a persuasive vision and connecting with people

Determination: The wherewithal to fight for difficult goals despite challenges and to bounce back from adversity.

be contributed on the same issue, but not so much that there is redundancy or that critical areas are overlooked.

Finally, director candidates should have the right temperament for the complex and uncertain environment in which a post-bankruptcy company operates. Our research into the profiles of business leaders who thrive in times of uncertainty, including directors of top-performing boards emerging from bankruptcy, found that they shared four key personal qualities: curiosity, insight, engagement and determination. Incorporating these traits into the assessment of potential directors will help give the board the resiliency and agility it needs to meet the challenges ahead.

No one is better positioned than the chairman to set the tone of the board's culture and dynamics."

From *Unlocking Great Leadership: How Chairmen Enhance Board Effectiveness*

In combining experience, judgment and temperament, the objective of the company's creditors (and to an extent, its debtors) should not be to build a star-studded panel but rather a high-functioning body that is nimble enough to work toward both short-term and medium-term objectives, remain cohesive while having very direct and candid conversations and form a whole greater than the sum of its parts.

Have a strong foundation at the top

A well-chosen board will have the potential to become an agile and resilient team—but the extent and speed with which they do so depends largely on the leadership of the board chair. For this reason, the board search committee often begins by identifying the non-executive chair and then building around him or her. The board culture that the chair creates must enable and support the rigorous decision making that allows for unfettered debate and truth-telling while being able to move quickly on a seemingly endless procession of complex matters. The chair must balance the various interests around the table so that constituencies don't feel they are relinquishing too much in the many difficult, high-profile decisions that must be made.

In Egon Zehnder's global survey of board chairs, "Unlocking Great Leadership: How Chairmen Enhance Board Effectiveness," we found that in the face of increased shareholder demands for return on investment, the chair's ability to surface and regularly discuss risk is critical. This is particularly the case in post-Chapter 11 companies, where day-to-day circumstances can lead boards to focus too much on the short-term "what" at the expense of understanding the more substantial "how" and "why." Reaching this deeper understanding means not just looking at risks around, say, meeting financial targets, but also eliciting candid assessments from management, who may be reluctant to share issues that could reflect poorly on their performance. Yet these discussions can provide important insights to ensure that shareholder value is achieved. One chairman told of a simple but effective measure to help spur these conversations: At each board meeting, he asks the CEO to articulate the three things that are going right and the three things that are not.

Participants in our global survey also highlighted the importance of strong, experienced committee chairs who can foster candid discussion at the committee level just as the board chair does at the board level. There are a variety of approaches to committee composition in post-Chapter 11 companies, but no matter the committee roster, the committees need to play the critical role of bringing transparency to matters which directors may be hesitant to discuss in full board meetings, or which may not be allocated sufficient time on the board agenda. Committees are often where the right balance is found between overseeing a company and running it.

Closely monitor team dynamics

If it is critical for the board chair to shape the board culture and instill behaviors and practices that reinforce cohesion, then there also needs to be some mechanism for the chair to assess those factors—and to do so in near real time, so that needed adjustments can be quickly made. The board of a post-Chapter 11 company does not have the luxury, after all, to learn and then unlearn bad habits.

Board Dynamics Questionnaire

	Trending			
	Reverting	Same	Improving	Much Improved
Did the meeting agenda accurately reflect the challenges and opportunities facing the business across a range of time horizons?	●	●	●	●
Is the board aligned on strategic strategies?	●	●	●	●
Was management clear on the input they need from the board to resolve open issues?	●	●	●	●
Did the board prioritize discussion time to focus on strategic decision making rather than presentation?	●	●	●	●
Were proactive efforts made to surface risk?	●	●	●	●
Did each director fully participate in discussion, contributing his or her particular perspective, experience and expertise?	●	●	●	●
Was consensus reached in a way that allowed for a full consideration of opposing viewpoints?	●	●	●	●

The Board Dynamics questionnaire shown on previous page was developed to provide such feedback. The questions were used to frame a brief but candid discussion at the end of each board meeting to evaluate the board's alignment with the desired behaviors in the boardroom. This discussion provided the board chair and the entire board with insight and transparency into the emerging boardroom dynamic so that any issues could be addressed before they became full-scale derailers.

Post-bankruptcy boards are likely to meet more frequently than the standard four to six meetings a year is common for most companies. This taxing schedule will accelerate the formation of the board's culture. Closely monitoring that culture helps ensure that normative behaviors develop in a positive direction.

Constructing a board for an energy company emerging from bankruptcy can appear to be a daunting challenge. But it is also a rare opportunity to rebuild from scratch, unencumbered by legacy constraints. This is, of course, the point of bankruptcy. Companies and creditors that embrace this opportunity, despite its difficulties, are the most likely to emerge with the leadership and oversight necessary to thrive in an uncertain market. Applying these ideas will not only drive efficiency in filling board seats, but also improve the effectiveness of post-Chapter 11 boards to minimize the risk of company underperformance and to enhance the attractiveness of the company in the capital markets.

Authors

Steve Goodman
Houston
Steven.Goodman@egonzehnder.com
+1 713 331 6735

Trent Aulbaugh
Houston
Trent.Aulbaugh@egonzehnder.com
+1 713 331 6750

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