

Special focus:  
Government involvement  
in business

There can be little doubt that the massive levels of federal financial support and involvement are reshaping American business, particularly in the financial and auto sectors. And different levels of government involvement correspond to the differing levels of investment.

Seven major companies in banking, insurance, automotive, and related automotive credit (the Seven) have had material—even extraordinary levels of—government support, and so face the greatest degree of government involvement. Other (mostly financial sector) companies took TARP funds, and face a lesser, but still meaningful, degree of involvement. Even financial institutions that didn't receive any direct assistance face more regulation and oversight, which will likely change behaviors and operations to some degree. At the time of this writing, it remains to be seen what additional measures may be applied to the companies deemed “too big to fail.”

Policymakers have homed in on excessive risk-taking as a key contributor to the crisis. Many claim that deficiencies in performance measurement and incentive compensation structures promote excessive risk-taking that is out of sync with the long-term needs of some companies and, by extension, the health of the US economy. Shortcomings in the regulatory framework are being cited, as well as corporate governance practices.

The emergence of the government as a major shareholder in the auto, banking, and financial sectors raises a new set of challenges for directors at these companies. This section focuses mostly on the impact of government involvement at the Seven, what it means to these companies and their directors, and what it might mean to companies that transact with these institutions. A review of the impact of government involvement in three specific areas can help directors navigate the forces affecting them in their role as stewards of companies that have a complex mix of shareholders and other stakeholders to satisfy.

## Impact on boards and corporate governance

The government invested billions in the Seven and so became a major—if not the majority—shareholder. The boards of these companies have been transformed in a short amount of time, with many directors replaced. Some of the new directors were selected by the US Treasury and, in the case of the auto companies, also by the Canadian government and union interests. One focus was to bring more industry knowledge onto these boards, and that's evident in the backgrounds of many of the new directors.

The reformed boards bring a new dynamic to the boardroom as directors work with management (many of whom also are new) to implement turnaround strategies and to plan for the future. The scale of change in the boardroom amplifies the importance of directors getting to know one another and quickly gaining a robust understanding of the company and its operations. They must evaluate the company's strategies and risks and learn to work together constructively.

Assuring a positive dynamic is especially important given that many directors were placed on the board by different constituencies. They may find conflicting agendas emerge, such as when considering executive appointments in weighing seasoned, internal candidates against pressure to bring in outside talent. Political objectives also may influence board decisions.

In addition, these constituencies may have different perspectives simply from having different time horizons. The government investments in the auto industry are generally expected to be short term. On the other hand, some degree of government ownership in the financial sector may last for years, even though the government has signaled it's not intending to remain a long-term owner. If the government focuses on returning taxpayers' investments as quickly as possible, boards may find it difficult to gain consensus for a long-term strategic investment. Yet directors are aware they have broader responsibilities, which extend to the safety and soundness of their companies and entail decisions that require long-term investment.

Directors at the Seven are in a challenging position. Their decision-making authority in certain areas has been weakened. In other areas, the government may have veto power over a board's decisions. Even so, these directors' fundamental role in safeguarding all investors, including minority shareholders, remains intact. Just as directors should be prepared to challenge management on its business strategies and market assessments, they also should be prepared to discuss and challenge a government decision when they believe the decision is truly detrimental to the company's prospects. In that vein, directors may need to consider obtaining counsel from advisors as input to the board's deliberations.

What does this mean to directors of companies that deal with these companies—as a major customer, supplier, or counterparty? It means that since these companies may have had to evolve because of the changes in their leadership, it's vital to stay engaged with the companies and keep relationships strong. In addition, these companies may face pressures from within to buy from or deal with entities that are preferred by their new owners, thus creating an uneven playing field.

## Impact on compensation

Perhaps most significantly, the government's involvement in these companies has had a direct impact on executive compensation practices at the Seven. Treasury has determined pay packages for a wide range of executives at these companies—not just those at the top.

A key concern is that sharply reducing pay packages—or deferring a greater proportion of compensation—will drive talented executives to rival businesses or away from US companies altogether, particularly in the financial services sector. There is deep concern about the ability of these companies to recruit needed talent and to keep current employees motivated while pay practices remain uncertain. Directors should be prepared to make the case to any external overseers that the company needs to attract and retain talented people.

For directors of other companies, recognize that although the government or regulators might not have direct say over your company's compensation, scrutiny of executive compensation is spreading—not just by financial services regulators, but also by shareholders and employees. Indeed, many directors believe that even companies that are not participating in government relief programs will feel the effect of the government's moves in their compensation discussions. Accordingly, directors should consider the transparency of their processes for developing compensation levels and be able to explain or defend them if necessary.

## Impact on company operations and management

The impact of government involvement on operations and management may be harder to discern than on pay, but it remains influential. Some of the Seven have had to sell profitable business units. Others are constrained by the need for the government to approve major expenses. More noteworthy is simply the amount of time some executives are spending with regulators and the degree to which regulators and government officials are actively involved in the day-to-day operations of their businesses.

At some companies, this contact between management and the government is on a weekly—or even daily—basis. The benefits to open communications with government agents, including regulators, include a better understanding of each party's objectives and views and the status of issues. A downside is that intense government involvement can distract management, taking time away from the key operational focus that is particularly critical in this economy. [See *Appendix B: CAMELS Scorecard* for an example of how regulators are looking at companies.]

Lead directors or board chairs at some of these companies are becoming involved in the regulatory relationships. This helps them better understand regulators' concerns and monitor whether any issues are becoming roadblocks and need to be elevated to the entire board.

Government influence over operations also factors in when government funding is involved. Companies often make certain assurances before receiving the funds, and such assurances cover a range of obligations relating to how the money is spent. Directors should first be aware of these obligations and secondly understand the type of reporting the government may need. The reporting requirements, as government contractors have long understood, can be significant for accounting and finance departments. Finally, directors should be prepared to ask management how it is tracking the funding. In some cases, reporting requirements may mean government funds cannot be considered as fungible as general company funds.

Directors should be aware of the heightened reputational risk for their companies, as well as for government officials whenever they directly invest taxpayer money in companies: the “bad headline” risk. For a number of these and other companies leveraging government assistance, the consequences for “business as usual” practices have been striking.

Navigating the potential conflicts inherent with this level of government involvement presents a challenge for affected directors. Demanding transparency from management as to the company's opportunities, risks, and financial condition—and, importantly, understanding how these are viewed by its government investors—will help directors see potential issues approaching and work within this new board dynamic to make sound decisions that will benefit all shareholders.

**Directors should be aware of the heightened reputational risk when the government has invested in their companies.**