The Black Swan Pandemic & the Board of Directors: A Shift in Priorities

My research will study the vital role the Board of Directors played during this black swan crisis. Much will be written about how corporate governance could have helped companies prepare for the pandemic. But, in my proposed research, I seek to study how the pandemic itself impacted governance, or, in better words, how the pandemic changed the agenda and priorities of the Board.

I will frame my study in the context of the Canadian Oil and Gas Industry that has been harshly impacted by the lockdown. Due to the cancellation of air travel and limits on other forms of transportation, as well as the sharp decline in economic activity, the global demand for fossil fuels dropped. On the other hand, the pandemic did not disrupt oil production and oversupply started filling global storage sites to capacity. To make things worse, the OPEC+ negotiations failed, triggering a price war between Saudi Arabia and Russia. Global oil demand kept falling until there was negative demand. For the first time in history the oil futures settlement price became negative.

The Board of Directors is elected by the shareholders of a company but has broader responsibility to protect the interests of other stakeholders. For many companies, senior debt holders are important stakeholders. In the case of the pandemic, the entity value of many firms dropped substantially due to the business lockdown. This was compounded in the case of the Oil and Gas Industry by the oversupply and price war. Entity value is made up of the equity value of the firm plus the value of senior debt plus the value of subordinated debt. As the entity value falls, the equity value diminishes and eventually goes to zero. As the value of equity drops, the fiduciary role of the Board shifts towards protecting the value of debt holders. If entity value continues to fall, the value of subordinated debt falls because senior debt holders have priority in liquidation over the subordinated debt. Thus, while the Board of Directors has responsibility to guard the interests of all stakeholders, it has a special responsibility to the senior debt holders who are ultimately the residual claimants on the assets of the firm in liquidation or restructuring. This may leave the Board in a precarious position because the interest of senior debt holders may conflict with the interest of subordinated debt holders and other parties such as landlords and employees.

Therefore, the focus of my study is the shift in the agenda and priorities of the Board of Directors' based on their fiduciary responsibilities to the financial stakeholders of the firm. The shift from a shareholder-focused board to a senior-debt-focused board is similar to the shift in valuation that Hayn (1995) recognized for loss firms, due to the liquidation option, in her paper "The information content of losses". When a firm is losing money, greater likelihood of liquidation causes asset values to change from "value-in-use" towards "liquidation values". In normal times, the Board has a primarily responsibility to the shareholders who want the firm to grow and prosper. Metrics such as market value, earnings growth and stock price are key variables of interest. During the pandemic, the declining value of the firm leads to a shift in responsibilities towards protecting the interests of senior debtholders. This has interesting implications because the senior debtholders want to protect asset value and control leakage. There are various sources of leakage. From the perspective of the senior debt holders, payments to subordinated debt (junior debt) represent leakage, dividend payments are leakage, capital spending may be leakage because it moves cash out of the company. Executive compensation, rent, and retaining under-utilized employees are all sources of leakage.

I want to study how Boards of Directors of Canadian O&G companies handled the shift from a shareholder focus to a senior debtholder focus. A prominent example is the change we observed in Suncor's financial strategy. Suncor announced a $1.5 Billion cut in capital spending for their 2020 annual budget in order to preserve cash. On April 8th, Suncor Energy raised $1 billion in new debt by issuing 10-year bonds, primarily to pay down currently existing and maturing debt. On May 5th, the company made a statement declaring a 55% slash in cash dividend payments. It lowered production and planned to lower its utilization rates in 2020 by almost 10%. All the actions taken by Suncor represented actions to preserve liquidity, limit cash leakage and preserve valuable long-term assets. Suncor is in a unique position because shut down decisions are very costly.

I will analyze how Boards and senior officers handled this shift in responsibilities by studying their actions during this period based on public disclosures, news articles, analysts' reports and other documents. I will also interview or survey members of Boards of Directors to learn about how their responsibilities changed during this period.