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Corporate Governance at Nortel – Board Functions and the Need for Redefinition

> Compared with their peers, the directors at higher-impact boards say they evaluate resource decisions, debate strategic alternatives, and assess managements understanding of value creation much more often. These respondents are also likelier than others to say their boards ensure that organizational resources are in place to deliver on strategy and that they manage strategic performance.
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> ~McKinsey Global Survey (2013)[1]

Executive Summary

The current model in corporate governance theory is predicated on management by CEO and his /her teams of executives, with directors in charge of oversight and monitoring. Corporate law endorses this model by authorizing directors to supervise management, rather than manage corporations by themselves (see e.g. *Canada Business Corporations Act*[2] *(CBCA),* section 102). Boards *are* the last line of defence in troubled companies. The Nortel experience suggests that boards that are mostly independent and the bare monitoring principle might not be adequate as universal principles, particularly in troubled, under-performing companies. Rather, the need in such cases is for an adaptive board that can respond to evolving situations.

The issue with independent directors and their function as monitors would be especially acute in a corporation that is facing challenges and is in need of re-strategizing for the medium and long term. In such situations, boards can better serve corporations and their stakeholders by having greater engagement with business strategy and becoming more proactive as necessary. The hypothesis about adaptive boards and their changing functions can be evaluated with the following events at Nortel:

- Churn in CEOs and succession planning
- Business acquisitions strategy
- Accounting misstatements and investigation
- Business oversight and bankruptcy filing

The Nortel experience can be valuable for updating and refining corporate theory. It indicates that the emphasis given to director independence and monitoring as the predominant board function might not be quite appropriate. These principles cannot be valid in all situations or at all times. Equally, it may not be sufficient for boards to simply include a cross-section of experts. Corporate theory must equally focus on the need to constantly review the level of director engagement with corporate strategy and affairs, and encouraging boards to be more entrepreneurial in appropriate circumstances.

The task is to develop adaptive boards that can respond to evolving situations and challenges. In good times, it might be sufficient for boards to play the background role of monitoring. But when dealing with headwinds and competitive pressures – or internal crises such as accounting restatements – boards may need to adapt to changing circumstances and recalibrate their role. Adaptive boards can craft their functions to suit emerging needs and provide stewardship in handling and overcoming challenges. An important lesson from the Nortel episode is that board functions cannot be static or limited.

The review of governance at Nortel in this study begins with an overview of the composition of its board between 1996 and 2009, and its implications. This is followed by a discussion of specific issues – namely, CEO selection, business acquisitions strategy, accounting investigation and bankruptcy filing, and their intersection with board oversight and monitoring. The study concludes with a reference to the increased sensitivity in corporate governance discourse to boards' role in strategic management and examines how engaged boards with a greater entrepreneurial flair can contribute to improving outcomes and preventing corporate failures.

To be fair, the story is not merely about the Nortel board and its performance. It is equally about corporate theory and the prevailing norms under which Nortel directors operated. This is about corporate governance and its character as a "soft law" subject; corporate law provides little guidance to directors about their functions. The law issues no rigid commands on how companies must be managed. This is perhaps as it should be. In this framework, influential ideas in the discourse on governance shape the functioning of corporate boards. In recent times, corporate theory has stressed director independence and the monitoring function. This can constrain boards from significant engagement and Nortel perhaps provides evidence of the limitations of this approach in fostering effective governance of large and complex corporate enterprises operating in global markets.

The analysis in this study is based on disclosures made by Nortel in its filings, media reports, and interviews with former executives. A necessary caveat in an exercise like the one attempted here is about its *ex post* character and 20/20 hindsight. The analysis presented here is with the benefit of knowledge about the events that unfolded, which the actors lacked at the time. Yet the Nortel episode can offer lessons about large transnational business corporations understood as complex organisms and the limitations of some of the recent postulates on their governance and oversight.

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Corporate Governance at Nortel – Board Functions and the Need for Redefinition

A. Nortel Board, 1996-2009

To interpret the composition of Nortel's board during 1996-2001, it is necessary to step back about 60 years – to the 1930s when Berle and Means published their seminal work on corporations, the economic power wielded by their managements, and relative shareholder inefficacy.[3] At the time, the boards of public corporations mostly consisted of executives or managers, and there were complaints about the vast and unchecked economic power held by these boards. Reflecting the complaints, the composition of corporate boards changed significantly in the decades that followed. Emphasis shifted to directors who were independent from managements and their ability to effectively monitor managers (see e.g. Dey Report 1994[4]).

As a result of the developments, the percentage of external, non-executive directors on public company boards has been on the rise since the 1960s (Jeffrey Gordon 2007).[5] The trend strengthened with the emergence of the "agency costs" issue in the governance discourse in the 1970s (Jensen & Meckling 1973).[6] The complaints against agency costs reinforced support for monitoring boards. These were, in sum, the logic behind the dominant ideas in corporate governance – namely, external directors who were independent of managements and oversight of managements by boards. To be clear, these notions emerged in the 1960s and 1970s which represented the high noon of industrial corporations in North America. This was the pre-globalization era when the corporations operated in more secure markets, wielded significant power and controlled huge resources. This was the setting in which ideas about monitoring boards were developed.

Another and more recent strand in the discourse on corporate boards is the blend of skills that directors must possess. The idea here is that having experts from different disciplines and areas such as industry, banking and finance, law, and public service and politics, will promote appropriate "matrix of skills" in boards of directors (see e.g. Conference Board 2013).[7] The expectation is that boards with broad-based skills will be more effective in their function (see e.g. CalPERS 2010).[8]

Between 1996 and 2009, which is the period selected for this study, the Nortel board represented an impressive blend of skills, experience, and standing of individual members. The directors represented a combination of skillsets that not only included the company's core business – namely, telecom, but also several other backgrounds such as automobiles, aerospace, banking and finance, research, governance, consumer products, politics and public life, and law. Table 1 below provides details of the composition of the Nortel board from 1996 to 2001.

Table 1

Nortel Board Composition, 1996-2001[9]

					Other External Directors' Background				
	Total Number of Directors	**Nortel Executives on Board**	**BCE Nominees on Board**	**Other External Directors**	**Telecom Business**	**Non-Telecom Business**	**Law**	**Investment/ Other**	**Number of Board Meetings**
1996	13	2	2	9	0	4	2	3	12
1997	13	2	1	10	0	4	3	3	13
1998	15	2	2	11	0	5	3	3	Not reported
1999	12	1	2	9	0	4	2	3	17
2000	10	2	0	8	1	3	2	2	19
2001	11	2	0	9	1	3	2	3	24
2002	10	1	0	9	1	4	2	2	30
2003	13	1	0	12	2	6	3	1	20
2004	13	1	0	12	2	6	3	1	34
2005	12	1	0	11	1	6	2	2	31
2006	11	1	0	10	1	4	2	3	26
2007	11	1	0	10	1	4	2	3	Not reported
2008	12	1	0	11	1	4	2	3	Not available
2009	10	1	0	9	1	3	2	3	Not available

In keeping with the trend for boards to have a greater ratio of non-executive directors, Nortel only had its CEO on the board in nine of its last fourteen years; after 2002 the CEO was the only executive on the board. Among the early years until 2001, there was one other executive on the board except in 1999. In 1996 and 1997 when Jean Monty was CEO, he had with him John Roth on the board. Roth succeeded Monty as CEO in 1997. In 1998 Roth had with him on the board David House, with the title, “President.” House had come from Bay Networks and was its CEO. Bay Networks was a very large acquisition Nortel made paying $9billion in stock. As mentioned earlier, CEO Roth was the only executive to sit on the board of directors in 1999. In 2001 and 2002 the board included Roth and Frank Dunn who was then CFO. As is explained a little later, Dunn succeeded Roth as CEO in late 2002.

The board composition in 1996-2002 suggests that there was a practice for CEOs to have their second-in-command to sit with them on the board, presumably to groom them for succession. This ended with Frank Dunn who became CEO in November 2001. Dunn who was terminated in April 2004 in the aftermath of the accounting issue did not have any other executive with him on the board.

The Nortel was board was also largely independent, as evident from the numbers seen in the table above. The emphasis on director independence and the efficacy of independent directors have been subjects of debate. Warren Buffett (2002) was among the early critics (more recently, see e.g. Libov, Sepe, & Whitehead 2013).[10] There is greater sensitivity to the limitations of independent directors and questions have been raised about their engagement with corporations. These issues are particularly relevant in a company such as Nortel that operated in a dynamic business environment and had, at best, a bumpy business record. In any case Nortel, consistent with contemporary governance prescriptions, had a largely independent board.

Equally, Nortel board had a sound matrix of skills. Till 1999 BCE Inc., which is the holding company of Bell Canada, held controlling interest in Nortel and it had two representatives on Nortel board. This ensured the presence of directors with expertise in telecom industry. After BCE's exit, board representation from BCE ended but Nortel still had at least one other external director with telecom background in the following years. Industry expertise thus continued on the board. This strength was complemented by directors from a range of business and professional backgrounds that included, as indicated earlier, automobiles, research, law, investments and finance, and public service and politics. The Nortel board also ticked the box in the matter of directors' wide-ranging expertise. The board infrastructure was thus in good shape and could be considered capable of providing stewardship in critical times.

Nortel board had a major revamp in 2005. This was a critical year that followed the accounting imbroglio and the termination of Frank Dunn as CEO in the context of the controversy surrounding the financial restatements. The changes that were made to the board were hailed by shareholders (see e.g. Globe and Mail 12 Jan 2005). However the composition of the board, in terms of matrix of skills and the credentials of individual members, continued more or less as before. The revamp did not radically change the board's complexion as evident from Table 1.

Nortel directors also met frequently. Data on the number of board meetings is available for ten of the fourteen years, as presented in Table 1 above. Starting from relatively modest numbers, meeting 12 times in 1996 and 13 times 1997, the number of board meetings increased in the years that followed. The board met 17 times in 1999 and the number of meetings climbed to 24 in 2001. It peaked at 34 in

2004, the year in which Nortel had the accounting restatement problem and terminated Frank Dunn as CEO. From the number of meetings the Nortel board had in most of the years, it is apparent that the directors committed considerable time and their level of engagement was also substantial. Here again in the matter of frequency of board meetings and commitment of time by the directors, the Nortel board was in compliance. Data is not available on the number of meetings held in 2008. This was the crucial year in the run-up to the bankruptcy filing decision made by the board in January 2009. Considering past trend, it is probable that Nortel board met as necessary to discuss matters.

To reiterate, Nortel had a board with competent and seasoned members. The company's directors had an arguably sound mix of skills and devoted substantial time to board meetings. The questions that remain are about the content of the oversight function performed by the board. The next section analyzes board performance and oversight in the context of the specific issues that have been identified – namely, CEO selection and succession planning, business acquisitions strategy, accounting restatements and finally, business oversight and bankruptcy filing.

B. Board Performance and Oversight – Content and Outcome

In corporate theory, the monitoring or overseeing board has been advocated at least since the 1970s (see e.g. Melvin Eisenberg 1976).[11] As noted earlier, there has been an equal stress on the independence of directors. The influence of these ideas is evident in Nortel board.

The discouragement of executive presence on boards and the emphasis on monitoring can be viewed as constraining influences. On the one hand, they deter boards from adopting proactive approaches and from seeking significant involvement in corporate strategy. On the other, the notion is also likely to encourage candidates who do not wish to be seriously engaged with corporations to seek and accept board positions.

Since the 1990s, there is evidence of greater sensitivity to the limitations of the monitoring board model. A result has been a trend to assign more specific functions to directors. The Dey Report (1994), which was commissioned by the Toronto Stock Exchange in the wake of a series of corporate failures, listed four responsibilities for boards. These included (a) succession planning and appointment of senior management and (b) adoption of corporate strategy. In 2001, the Saucier Report,[12] which reviewed the Dey Report recommendations and their implementation, expanded the stress on boards' role in these areas. To improve board effectiveness, the Saucier report advocated board approval of strategic planning process and strategic direction, and in defined circumstances, board approval of major corporate decisions. Thus at the level of doctrine, it is recognized that boards must have greater engagement in key areas beyond simple monitoring from the agency costs standpoint.

The issues at Nortel identified for analysis in this study – namely, CEO selection and succession planning, acquisitions strategy, accounting investigation, and business oversight and bankruptcy filing are included among board functions in current corporate theory. Understanding the related events at Nortel is helpful in the efforts to better define the role of directors. Quite obviously, the issues that have been selected for analysis are connected to one other; they are not standalone in any sense. To illustrate, the board's decision to terminate Frank Dunn as CEO in 2001 was directly related to the accounting issue and the report issued by Wilmer Cutler Pickering Hale and Dorr LLP ("Wilmer Cutler"), the US law firm engaged by Nortel board to inquire into the restatements. Similarly, the business acquisitions Nortel made in the late 1990s and the policy of expansion that accompanied impacted operating performance. This is again linked to board oversight of business. The interlinking nature of the issues is apparent in the discussion below.

1. Churn in CEOs and Succession Planning

Like most other corporations in North America, Nortel was a CEO-led enterprise rather than one led by its board of directors. The company had a linear leadership structure and its chief executive held a pivotal position. Nortel had a multi-divisional business model in which the CEO played the connecting and leadership roles. In recognition of the vital position of CEOs and their impact on corporate success, boards are charged with the responsibility to select CEOs and to have in place sound succession plans.

At Nortel, it is apparent that CEO selection and succession planning had a major impact on the turn of events. There was considerable churn in CEOs between 1996 and 1991, which are the years under review. During this period, as pointed out, Nortel had five CEOs – namely, Jean Monty, John Roth, Frank Dunn, William Owens, and Michael Zafirovski. Five CEOs in fourteen years can be a serious issue. Among the five, only Monty completed a five-year term in 1997. Others did not. In May 2001 Roth, then three-and-half years in office, announced that he will retire in April 2002 before completing the five-year term that is standard for CEOs (Globe and Mail 12 May 2001). But Roth withdrew, at least partially, even earlier in October 2001, appointing Dunn as CEO. Roth became vice-chair temporarily. Dunn was terminated after less than three years. Owens, who was appointed as interim CEO after Dunn, left after less than two years. Zafirovski became CEO in November 2005 and Nortel filed for bankruptcy in January 2009, early in the fourth year of Zafirovski's term.

The standard term for CEOs is five years and a common practice is to reappoint CEOs for at least one additional term. CEOs holding office for five to ten years is generally considered appropriate. It reflects the common sense notion that it takes some time for a person to settle down in his/her position

and about the time that is needed for providing effective and stable leadership. The churn in CEOs at Nortel is significant from this standpoint.

Other than the five CEOs who actually held office, Nortel considered appointing Gary Daichendt of Cisco Systems as CEO and had him as President and COO of the company for three months from March 2005 (Globe and Mail 20 June 2005[13]). Daichendt worked under Owens. Earlier, John Roth had appointed David House of Bay Networks as President in 1998, but House did not last either. This was a part of the difficulties Nortel experienced in implementing Bay Networks acquisition and integrating its business.

The swift turnover at the top and the number of CEOs Nortel had in a relatively short period of time are pointers to the leadership problems in the company. For practical purposes, stable leadership ended with Jean Monty who left Nortel in 1997 to return to BCE. The tenures of the last five CEOs of Nortel are presented in following table.

Table 2

Nortel's Last Five CEOs – Term of Office

CEO	From	To	Months in Office
Jean Monty	Oct 1992	Oct 1997	60
John Roth	Nov 1997	Oct 2001	48
Frank Dunn	Nov 2001	Apr 2004	29
William Owens	Apr 2004	Nov 2005	18
Michael Zafirovski	Nov 2005	Jan 2009	39

Another significant feature is the diverse backgrounds of the CEOs. Monty who began in 1992 was a BCE veteran. Roth who came next had been with Nortel since 1969. He joined Nortel as a design engineer. He rose through the ranks over the next twenty-plus years and sat on board in 1996-97 before his appointment as CEO. After Roth came Frank Dunn, an accountant by background and CFO since 1999. Dunn, who became CEO in November 2001, was on the board of directors with Roth since the previous year (2000).

Dunn was terminated by the board "with cause" in April 2005, following the report of the US law firm, Wilmer Cutler, on the accounting issue. William Owens, who had been among other things an admiral in the US Navy, succeeded Dunn as interim CEO. Owens headed Nortel for about one-and-half

years until November 2005 when the board appointed Michael Zafirovski as CEO. Zafirovski had held senior positions in General Electric and Motorola.

The CEO churn must be understood in the business context in which it happened. Nortel faced serious challenges since 2001 when the Internet boom in the stock market ended, triggering a recession. The company suffered setbacks and launched an enormous restructuring exercise, reducing its workforce from over 90,000 to about 30,000. This was downsizing by two thirds and it substantially undid the expansion that had come in the 1990s with a spree of acquisitions.

The restructuring was swiftly followed by the accounting scandal, termination of Dunn and other senior managers and shareholder lawsuits. The last CEO, Zafirovski, was in the midst of implementing his set of reform measures when the Credit Crisis began in September 2008. This seriously affected the revenues of Nortel, raising questions about its future. It was the immediate trigger for the bankruptcy filing in January 2009.

The last decade or so of Nortel's existence was, thus, quite eventful. Several things happened – some internal (acquisitions, expansion, accounting restatement) and some external (end of the dotcom bubble, recession, Credit Crisis of 2008-09). During this period, the company had instability at the top and a board made up almost entirely of external, non-executive directors who lacked in-depth knowledge of its business and the problems. The absence of a stable and effective CEO coupled with a predominantly external board would place a company, in particular one facing business challenges – such as Nortel. In the business environment that prevailed, stable, effective, and committed leadership was crucial and the board of directors would have the responsibility to ensure this. From this perspective, the events surrounding the changes of guard at Nortel were significant.

John Roth (1997-2001) was the choice of his predecessor, Jean Monty, who had groomed him for the position. As pointed out, Roth was inducted into the Nortel board in 1996, a year before his appointment as CEO. Under Roth, Nortel made its entry into the Internet space with the "Right Angle Turn" (RAT) campaign in 1998. The strategic value of the move is obvious, but a potential issue is about implementation. Even the method chosen – namely, a spree of acquisitions can be considered appropriate for the strategy of inorganic growth. But a more serious issue was about Roth's commitment to seeing through the successful implementation of the initiative.

In May 2001, during his fourth year in office, Roth announced that he will retire in April 2002. According to reports, Roth had made it clear even at the time of his appointment as CEO that he will not serve a full term of five years. If this were so, it raises questions about the directors' stand on the launch of a major strategic initiative under the leadership of a CEO whose departure date was already set. The

issue gets more complicated because of the lack of clarity about Roth's successor, which is discussed below.

About a year earlier in April 2000, during the heady days of the dot-com bubble in the stock market, Frank Dunn who succeeded Roth had joined Nortel board. He was the other executive on the board with CEO Roth. This could be interpreted as in keeping with Monty's practice of having the next potential CEO on the board along with the current CEO. But this is contradicted by Roth's statement in May 2001 while announcing his planned retirement in April 2002 that Nortel will look for a successor and terming a "smooth and orderly succession" a "priority" (Globe and Mail 12 May 2001).

There was also Clarence Chandran who, according to media reports, was a potential successor to Roth (see e.g. Globe and Mail 28 June 2000). Chandran. A Norteller for over 15 years, Chandran was appointed as the Chief Operating Officer (COO) in June 2000. This was a few months after Dunn's elevation to the board. However, Chandran went on medical leave in March 2001, less than a year after his appointment as COO. Roth, while announcing in May 2001 his plan for retirement in April 2002, also stated that Chandran will not return to Nortel and was not a contender for the CEO position. This was in the context of his statement about finding a successor and Roth's reference supports the earlier media reports that Chandran was indeed in the running for the top job at the company. If this were so, it is not clear why Dunn had been made a director in April 2000, three months before Chandran's appointment as COO in June 2000.

In any case after announcing in May 2001 that Roth will be CEO for the next year, months later in October 2001 Nortel created an "office of the chief executive" and appointed Dunn as CEO. Under the arrangement, Dunn shared leadership responsibility with Roth who remained as vice-chair and Lynton Wilson, originally a BCE representative, as executive chair. The threesome made up the office of the CEO. The arrangement was unusual, pointing to the tensions that prevailed within Nortel at the time. The development attracted media comment (see e.g. Globe and Mail 4 Oct 2001). At the time Nortel chair, Lynton Wilson stated that Dunn had been chosen after interviewing several internal and external candidates and the board was sensitive to the challenges the company faced (Globe and Mail 3 Oct 2001[14]). When Nortel adopted this leadership committee arrangement, it faced daunting challenges that included:

- steering the company through the recession that followed the deflation of the dot-com bubble,
- managing the strategic initiative that had been launched recently, and
- internal restructuring at Nortel initiated as a response to the recession

In any event, Frank Dunn who began his shared CEO position in November 2001 assumed full charge in April 2002 (Globe and Mail 1 Mar 2002).[15] The unorthodox method adopted for Dunn's elevation to the top – namely, creating an office of the chief executive that included Roth and Wilson suggests that the board lacked complete confidence in Dunn (see e.g. Globe and Mail 4 Oct 2001[16]). Dunn's term as CEO ended prematurely, and in unhappy circumstances, following the report of Wilmer Cutler on the accounting restatements. Dunn was terminated "with cause" by Nortel board on April 28, 2004, along with Douglas Beatty, CFO and Michael Gollogly, Controller. Beatty and Gollogly had gone on paid leave about six weeks earlier, on March 15. On Dunn's termination, Admiral William Owens, who had been a director of Nortel, was appointed CEO.

The events raise significant questions from a governance perspective. To begin with, Nortel was already in serious problems in April 2004 when Dunn and his team were terminated "with cause." The development further weakened the company that passed into the hands of Owens. William Owens had been a director of Nortel, but lacked industry expertise. Nortel did not state that Owens' appointment was on an interim basis, quite possibly to avoid sending a message of further uncertainty. The merits of the decision not clarify the nature of Owens' appointment is debatable considering Owens' background. In any case, there was a perception in the market that Owens would only be an interim CEO (see e.g. Globe and Mail 29 Apr 2004[17]).

There is no clarity on the level of preparation and succession planning informed the board's decision to terminate Dunn and his senior finance team with cause, end of April 2004. According to reports, the decision to terminate Dunn and his finance team was made at the meeting held towards end of April 2004, but clearly the underlying difficulties had been known even earlier. This is evident from the decision in mid-March 2004 to place Beatty and Gollogly on paid leave.

The questions that arise are whether the board was right in terminating Dunn quite suddenly and whether it had a succession plan in place before doing so. This is particularly important for a company in trouble, such as Nortel. It would be harder for such a company to cope with uncertainty at the top and lack of clear direction. The question is relevant not merely for this single episode – namely, termination of Dunn, but from the perspective of the governance culture in Nortel. Understandably, the events attracted negative media comments (see e.g. Globe and Mail 29 Apr 2004[18]).

It is possible to rationalize the actions of Nortel board from the standpoint of director independence and monitoring – the two themes that have received emphasis in corporate governance discourse. On becoming aware of potential accounting issues, the board acted in a way consistent with its independence and responsibility to oversee Nortel management. It engaged an independent law firm

from the US to investigate the issue and, acting on the recommendations of the law firm, it terminated senior officers of the company. All this happened in 2003-04 when the US was just recovering from the Enron/WorldCom debacle of 2001 and the *Sarbanes-Oxley Act* that criminalized financial misstatements had been introduced a year earlier, in 2002.

From a legal perspective also, it might be possible to justify Nortel board's decision to terminate the senior management team. The law permits directors to rely on the advice of experts and courts have developed the business judgment rule that enables substantial deference to corporate decisions. The directors acted according to expert advice and exercised their judgment in doing so. The devices available in law possibly cover the actions of Nortel board. These issues are discussed in greater detail in the Section (c) below, which deals with the accounting investigation. In any case, there can be little doubt that the sudden termination of Frank Dunn and his finance team further weakened Nortel.

There was a perception, pointed out earlier, that William Owens who took over from Dunn was an interim CEO. It is not unusual for companies to appoint a director as interim CEO when an incumbent departs suddenly – like it happened in Nortel with Frank Dunn (see e.g. Globe and Mail 31 Oct 2005[19]). But Owens stated that he expected to remain for the long-term (Globe and Mail 29 Apr 2004[20]). This was not to be. He stayed for almost one-and-half years until November 2005, when Michael Zafirovski succeeded him in November 2005.

The transition, once again, was clouded. To begin with, there was no clarity on Owens' term of appointment. Gary Daichendt, formerly of Cisco, was appointed President and COO in March 2005 and he continued until June. Daichendt's departure was also quite sudden and according to reports, he was not willing to wait till Nortel elevated him as CEO (Globe and Mail . This can be cited as indication of lack of clarity on Owens' position as CEO and the all-important question about the length of his term. In any case, by October 2005 Zafirovski from Motorola was identified and he began his position in November. Zafirovski had a reputation as a turnaround specialist. In hiring him, Nortel had to pay $11.5million to settle a lawsuit filed by Motorola alleging that Zafirovski's appointment infringed the non-compete agreement Motorola had with him (Globe and Mail 12 Dec 2005[21]). The lawsuit again raises questions about the level of preparation that went into the decision to hire Zafirovski.

While a stable company might be able to live with serious leadership issues of the kind outlined above, the case would be different for a faltering giant that Nortel was at the time. Another important question is, did the CEO churn and the complications in succession amount to governance deficiencies? The answer is not straight forward. Quite obviously, the directors responded to events as they unfolded. They were probably not proactive in trying to take control of events or foreshadow them. But the

question is whether this was inappropriate considering the monitoring role that corporate theory assigns boards. Monitoring carries a suggestion of *ex post* intervention, rather than *ex ante.* Therefore in evaluating board actions, it is important to also consider if the assessment is made according to correct standards.

2. Business Acquisitions, Corporate Strategy, and Shareholder Value

The next issue that is significant from the perspectives of governance and board oversight is the new business strategy Nortel adopted in the late 1990s. This was the "Right Angle Turn" initiated in 1998 for entry into Internet and wireless communications business. Internet had emerged as the latest and most versatile means of communication and cell phones were becoming hugely popular. For a telecom company of longstanding, such as Nortel, it made eminent sense to enter these greenfield areas. As a strategic initiative, there can be little doubt about the value of the Right Angle Turn. Nortel opted for the inorganic model of growth and went in for purchase of existing companies, rather than try to build the business from the scratch. This was again sensible as it would help Nortel climb the ladder without having to go through the learning and building curve. Between 1998 and 2001, Nortel made 19 acquisitions for a total purchase price of over $33billion.[22]

Nortel's Right Angle Turn happened during the dotcom boom in the stock market. The market warmly applauded Nortel's entry into the Internet space and offered stupendous valuations to its shares. From around $115 in November 1997, Nortel shares touched a peak of $860 in July 2000 at the height of the Internet bubble. This appeared to affirm the company's strategy, at least in the short run when the bubble lasted. The phenomenon would also have significant implications for board oversight. When a management delivered shareholder value on the scale indicated, a monitoring board consisting of independent directors could hardly display conservatism or adopt a probing, questioning attitude in regard to a strategy that was obviously paying rich dividends.

The Right Angle Turn initiative was, however, not without gaps and omissions. This is evident from some of the results that followed. At the operational level, the shortcomings included issues with respect to valuation of the businesses that were acquired and there was also apparently no clear strategy to integrate the acquisitions with Nortel's existing business. These problems were compounded by the absence of a leadership committed to seeing through the implementation of the major initiative and the accompanying policy of expansion that had been adopted either without sufficient preparation or based on a very optimistic view of the future.

The governance aspect and the issue of board oversight can be better appreciated with a sense of the scale of the acquisitions. As noted earlier, Nortel made at least 19 acquisitions during 1998-2001,

for a total price of over $33billion. The purchase consideration was paid mostly in shares. Over two-thirds of the value, $22billion, was accounted as goodwill and another twenty percent ($6.9billion) was recorded in Nortel's books as "acquired technology" and "in-process R&D." Amortization of these assets is standard practice, and this was also followed in Nortel. Other than amortization, in 2001-02 Nortel charged a total of $16.9billion towards "goodwill impairment" and "other special charges." This figure, taken from its 2003 balance sheet, represents over half the value Nortel paid for the acquisitions. Understandably, this had a major impact on the business results in these years.

The write-offs also raise questions about the accuracy and reasonableness of the consideration paid for the acquisitions, and the effort and preparation that went into valuation of the businesses at the time of the transactions. A relevant question is how far the valuation exercise was influenced by the fact that Nortel paid for the acquisitions with its shares which traded at high prices at the time. According to the annual filings, Nortel issued over 372 million common shares between 1998 and 2001 towards the businesses it purchased.

The business acquisitions were undoubtedly on a significant scale, warranting attention of the board of directors. Nortel, it is learnt, followed standard corporate practice for the purchases it made. The proposal would originate from business managers, cleared by the CEO and then placed before the board for approval. In the case of some big-ticket acquisitions, such as Bay Networks, CEO had greater and direct involvement, initiating and leading the transaction. In either case, the matter would come before the board for consideration and approval. The acquisitions were made with the formal approval of the directors.

The issue regarding board oversight of the acquisitions is complex. It must be understood in the overall business context of Nortel. As pointed out earlier, the company's business record had been indifferent at least since the late 1990s, including 1998-2000 when its share prices peaked. In the thirteen years from 1996 to 2008, Nortel had operating profits in six years and losses in the remaining seven. This kind of business performance deserved obvious board attention and must have informed the monitoring culture in Nortel. This subject is discussed again in Section 4 below, which deals with business oversight and the decision to file for bankruptcy.

Another factor was the "shareholder value" mantra and its sway in the 1990s. It was the era of "shareholder value" in corporate governance. Several large corporations in North America adopted shareholder value as their documented goal (see e.g. Michael Porter 1997[23]). The trend became stronger as the decade progressed and the dotcom frenzy carried the stock market to new highs. In the dizzy environment of the times Nortel, a veteran player in telecom, launched its Right Angle Turn and

entered the fancied Internet business space. The market was enthused by the acquisitions Nortel made for the Internet and wireless communications business and, as pointed out, offered handsome valuations for the company's shares. Nortel shares peaked at $860 in July 2000.

In sum, Nortel in the late 1990s was a company delivering excellent shareholder value. CEO John Roth was widely respected and admired for having launched the company on a new path of growth and prosperity. In 2000, he was named the Outstanding CEO of the Year and awarded an honorary doctorate by Concordia University.

The issue about board oversight, including acquisitions, can make better sense viewed against the milieu which was certainly positive. Nortel had a highly-respected CEO operating, nominally, under the watch of a board made up of independent, external directors. The acquisitions strategy, the brainchild of the CEO, had been well received in the stock market. The dynamics of the equation are apparent. Given the dominant board culture in North America, it would be challenging for the directors to seriously review – leave alone question – the business strategy and the strategic acquisitions made by Nortel acting under the lead of its CEO.

The issues surrounding the acquisitions are thus complex and call for nuanced understanding, from the perspective of governance. The experience underscores the need for defining board functions with greater clarity and ensuring that the enterprise remains profitable and sustainable. A board culture that took business profitability with greater seriousness might have probably led the directors to pay closer attention to the growth strategy, acquisitions, and related issues such as business valuations and issues of shares towards the purchases.

There is also the question about the business outcomes of the acquisitions made by Nortel. Regardless of how the stock market viewed the acquisitions, it is apparent that there was some disquiet among Nortel's customers. Many of the new businesses that had been acquired – for example, Bay Networks for $9billion – could not be successfully integrated with Nortel's existing business. As a result, the company ended up becoming weaker in its core business as a result of the acquisitions. This points to a disconnect between the stock market response and product market response to the growth strategy of Nortel and the practices that were adopted. It perhaps underscores the priority the product market must receive over the stock market in the governance of large and complex enterprises such as Nortel. These issues are discussed in the concluding part of this study.

In the setup that prevailed in Nortel and given factors such as the boom in share prices, it would be unrealistic to expect the directors to be more interventionist in regard to the acquisitions that were placed before them for approval. Indeed, to do so would be perceived as an intrusion on the company's

growth plans. An important question is whether greater caution in acquisitions, possibly at the instance of the board, might have produced better results. There can be no clear answer. In any case, it would be quite legitimate for a monitoring board to adopt a questioning and probing attitude. But those were the good times and this would discourage conservatism and caution among the independent directors. To paraphrase Warren Buffett (2002), collegiality probably trumped independence. A potential lesson from the episode is about the need for corporate theory to be more expansive and specific on the scope of monitoring.

3. Accounting Restatement and Investigation

The accounting restatements made in October 2003 were a major factor in Nortel's meltdown. They were the cross on which the crucifixion of Nortel began. There was a tendency to make hasty (and ill-informed, as it turns out) comparisons to Enron of US (see e.g. Globe and Mail 29 Apr 2004[24]). There was a belief that the restatements were meant to report profits that were not genuine and use this for paying bonuses to Nortel executives. The restatements had serious consequences. It led to the board engaging the US law firm Wilmer Cutler to investigate the issue and the termination "with cause" of CEO Frank Dunn and his finance team in 2004. This was followed by class action lawsuits by shareholders and a high-profile prosecution of Dunn and two senior executives, Douglas Beatty and Michael Gollogly, for fraud. The developments severely weakened Nortel at a time when it was facing grave business challenges and exacerbated its leadership problems.

RCMP's prosecution ended in acquittal in early 2013 (*R v Dunn*[25]). In a 140-page judgment, the Ontario Superior Court of Justice cleared the Nortel executives of criminal wrongdoing in the accounting restatements and related issues. The verdict is final as RCMP made a decision not to appeal (Globe and Mail 12 Feb 2013[26]).

The accounting restatements and related events are significant from the governance standpoint. As noted, the decision to engage Wilmer Cutler was made by the Nortel board as was the decision to terminate Dunn and his senior finance team members, based on Wilmer Cutler's recommendation. For analysis, it is helpful to identify the two distinct parts of the issue – namely, (a) the restatements and their correctness, and (b) actions taken by the board which included initiating an investigation, management of the process and dealing with the recommendations made by the investigating agency. These issues are separate, though related, and each had a bearing on the outcome. They are discussed below.

a. The Accounting Restatements at Nortel

The events make better sense when Nortel's accounting restatements are placed in their context. In the external environment, 1990s was the shareholder value era and the dotcom bubble developed in the stock market. In this milieu, accounting issues and earnings management practices were not uncommon in public corporations (see e.g. MacAvoy & Millstein[27]). Second, the early 2000s were virtually the Enron epoch in corporate governance. The accounting misstatements at Enron were coupled with wilful wrongdoing and disregard of ethics. The practices at Enron generated outrage and led to intervention by the US Congress, which enacted the *Sarbanes-Oxley Act*[28] in 2002. The *Sarbanes-Oxley* criminalized financial misreporting by companies. Corporate financial reports were, thus, at the centre of attention when Nortel announced its restatements in October 2003.

Additionally at Nortel, there were other factors at play. The company had grown in size dramatically in the late 1990s, and when economic recession hit in 2000, Nortel went in the reverse mode. It shed employees and closed down offices, on a massive scale. By 2002, the headcount came down to 37,000 from 94,000 before the recession. This was downsizing by over 60 percent, remarkable for its scale. The provisions for expenses and liabilities Nortel had made in its accounts, and which were restated, must be understood from this perspective.

In 2003, Nortel determined that it had made excess provisions in earlier years to the extent of about $950million and decided to reverse the surplus by "releasing" them from provisions. This was the "First Restatement" discussed in the summary of findings and recommendations of Wilmer Cutler provided by Nortel board as a part of the 2003 annual filing ("Wilmer Cutler Summary"). By the First Restatement, Nortel revised its financial statements for 2000, 2001, 2002, and the first and second quarters of 2003, reducing losses and correspondingly, increasing shareholders' equity and assets. For the first two quarters of 2003, Nortel reported profits under the First Restatement.

Wilmer Cutler's original brief was to review the correctness of the First Restatement and the releases from the provisions that formed the basis. The reports about Wilmer Cutler's conduct of the investigation and its influence on the board are significant. The firm has been has been criticized as overreaching and unduly aggressive (James Bagnall 2013[29]). In any event, they apparently persuaded the Nortel audit committee to extend their inquiry into the second and third quarters of 2003 also and this led to the "Second Restatement." According to Justice Marrocco of the Ontario Superior Court the Second Restatement, announced in March 2004, "had a much broader scope" (para. 353). But significantly, the criminal trial centered only round the First Restatement. The court noted that the

"causes of the substantial revenue recognition adjustments reflected in the Second Restatement were not developed in evidence" at trial (para. 352).

In discussing the provisioning practices that formed the basis of the First Restatement, Justice Marrocco noted the policy at Nortel to be "at the conservative end of the range when recording an accrued expense and liability (sic) estimating a particular risk" (para. 218). The natural consequence of such a practice would be to depress profits. In theory, the investigation by Wilmer Cutler was about the correctness of Nortel's decision to reverse some of the provisions that were found to be excessive or no longer necessary, and thereby increase profits. It is also now clear from the Ontario court's judgment that the First Restatement was initiated at the instance of Nortel's auditor, Deloitte, which proposed a comprehensive review of the balance sheet. This was approved by Nortel's audit committee. In other words, the company's independent auditor and its audit committee consisting of independent directors were involved with the restatement exercise at all times. Indeed, these were the main considerations for the court to arrive at the "not guilty" verdict in favor of Dunn, Beatty, and Gollogly.

There was also another technical accounting issue. This was about the period to which the released provisions must be allocated. The two obvious candidates would be the period in which the liability was originally created and the period in which the decision to release is made. In the First Restatement, Nortel apparently reallocated the releases to the periods in which the original provisioning had been made. And this had been signed off by the auditor, Deloitte. However, Wilmer Cutler raised an issue about the allocation periods and their compliance with US GAAP (Generally Accepted Accounting Principles). According to the Wilmer Cutler, Dunn and team loosely allocated the released provisions over several quarters to suit their earnings targets.

In assessing board oversight, the question is whether the accounting restatements outlined above warranted the measures that were taken by Nortel directors. The actions, undeniably, had serious consequences for the embattled company in terms of creating a leadership vacuum at a critical time and triggering class action lawsuits. It is, therefore, necessary to understand how the board dealt with the issue.

b. **Accounting Restatements and Board Monitoring**

As pointed out, the Nortel restatements in October 2003 happened at a time of hypersensitivity to corporate reporting and its integrity. The *Sarbanes-Oxley* had just been introduced and there were expectations of strict enforcement. It is understandable for directors operating in this environment to be cautious. The events at Nortel can be interpreted in terms of an anxiety on the part of the directors to avoid complications with US regulators in regard to the restatement made in October 2003.

To be clear, the restatement resulted from a combination of (a) conservative provisioning practices, (b) auditor's proposal for balance sheet review, and (c) involvement of the audit committee in the exercise. The auditor had also approved the restatements. Considering these, an option for the directors was to treat the restatements as justified and leave the matter at that. This meant living with the possibility of facing questions from regulators and having to answer them if the situation actually arose.

Another option was to be proactive. It is about reassuring regulators, investors, and the market that the restatements were appropriate and in order. There was also the element of protection for the directors against potential regulatory action. In this second option, a method would be to get the restatements reviewed by an independent agency. Nortel's audit committee and its independent auditor had already endorsed the restatements, and there should, in all probability, be no reason to fear any surprises. This thinking inspired the board's decision to engage an outside agency. There was a political element in the move; it was not just something done under the standard monitoring rubric in which directors operate. As monitors, the directors had already fulfilled their duty by involving the audit committee and getting the auditor to endorse the restatements.

It is possible, from a political perspective, to justify Nortel board's decision to seek external review. But there were problems in implementation, similar to the Right Angle Turn business strategy. The strategy itself made sense, but the quality of execution was questionable. To begin with, the choice of a law firm, that too from US, to investigate accounting issues needs explanation. The choice of Wilmer Cutler was influenced by apprehensions about risk of investigation of restatements by the Securities and Exchange Commission (SEC) and Wilmer Cutler's expertise in dealing with SEC-related issues. Wilmer Cutler hired a forensic accounting firm, Huron Consulting Services LLC, to handle the accounting aspects of the work assigned to it.

Another, and arguably key, issue is about setting the terms of reference for the investigation. This would be a delicate and challenging task. As pointed out, the original brief of Wilmer Cutler was to review the First Restatement. But it is not clear if Wilmer Cutler was given a well-defined brief about the investigation consisting of verifying the releases from provisions and their accounting treatment. In any event, the Wilmer Cutler Summary suggests that it was given a free hand in its inquiry and the methods:

> The Audit Committee expressly directed that requested documents be promptly provided and that employees cooperate with requests for interviews; the Audit Committee instructed senior management to implement these directions throughout the Company. Over the course of the inquiry, more than 50 current and former Nortel employees were interviewed, some more than

> once. While the independent inquiry did not examine the work of Nortel's external auditor, Deloitte & Touche LLP, several current and former audit engagement partners were interviewed. Hundreds of thousands of hard copy and electronic documents and emails were collected and reviewed from corporate headquarters in Brampton, from company servers, and from key employees in the business units and in the regions. (p. 95)

The extract suggests a freewheeling inquiry far beyond the limited damage control exercise that had been planned originally. Significantly, Wilmer Cutler Summary stated that it did not examine the work done by auditor Deloitte, the independent expert that knew Nortel's business for a long time and had endorsed the restatements. The methods adopted by Wilmer Cutler have attracted criticism. In James Bagnall`s words, Wilmer Cutler and Huron sent a "small army of associates and investigators" to Nortel. They spent over two years on the assignment and billed Nortel in tens of millions of dollars. Occupying empty offices, the investigating team would "turn their attention to downloading and organizing hundreds of thousands of business records and emails. They mixed uneasily with the Nortel staff who watched nervously [ ]" (Bagnall, p. 38). All through the investigation, Wilmer Cutler remained in touch with the audit committee of Nortel and provided regular updates.

The next issue is about the response of the directors to the findings and recommendations of Wilmer Cutler. As pointed out, there was a special setting in which Nortel board commissioned the investigation. The air was thick with the fetid Enron scandal and expectations of vigorous enforcement under the *Sarbanes-Oxley Act.* Understandably, Nortel directors were eager to avoid complications with regulators in the US about any accounting issues, potentially involving issues of board responsibility. These apprehensions inform the Wilmer Cutler Report Summary, as evident in the following statement:

> The Board of Directors must make clear that it has not tolerated, and will not in the future tolerate, accounting conduct that involves the misapplication of U.S. GAAP. (p. 99)

While the anxiety of the external independent directors is understandable, a question remains whether their reaction was proportional. In the Wilmer Cutler Summary, the principal charges against Dunn and team were that there were earnings targets which Dunn pursued with vigour and releases from provisions were switched among several quarters to suit earnings needs, and the allocation of releases were not in compliance with US GAAP. Among these, there can be little dispute with earnings targets and efforts to meet them; these are, after all, the functions of companies and their CEOs.

There is little suggestion in the Wilmer Cutler Summary that the releases were fraudulent, nor any allegations of reporting fictitious income or understating expenses. Indeed, the Summary showed Dunn in positive light with the observation that Dunn was instrumental in provisioning $175million in the last quarter of 2002 which resulted in a loss for the quarter, because he wanted to avoid payment of

bonuses to executives in a year in which the first three quarters had reported losses. But Wilmer Cutler charged Dunn with not sharing this "concerted provisioning activity to improperly turn a profit into a loss" with the board or the audit committee (p. 97).

The Wilmer Cutler Summary suggests a tone of inquisition. The material charge against Dunn and team, as pointed out, was non-compliance with US GAAP in allocating the provisions that had been released. As mentioned, there is no clarity on the terms of reference provided to Wilmer Cutler. Related to this are the issues whether Wilmer Cutler, a law firm, examined the implications of the reported non-compliance under securities law, in particular the newly-enacted *Sarbanes-Oxley Act,* and the question of liability of Nortel's directors and executives in this regard. To be clear, it is not as though with the entry of *Sarbanes-Oxley* every restatement would be criminal or companies were banned from revising their financial statements regardless of how justified a given restatement might be.

The fundamental question is about the legal consequences of the non-compliance of the Nortel restatements with US GAAP, found by Wilmer Cutler. In considering the liability of Nortel officers and directors, the special circumstances that prevailed in the company would be relevant. These included conservatism in provisioning and the massive restructuring that was implemented in 2001-02. These have be relevant in determining the due diligence defence recognized in law. The Summary Report contains no discussion on these issues.

In making recommendations, Wilmer Cutler adopted a combination of inquisitorial and advisory approaches. Training to employees and process improvements were among the prescriptions provided. A more controversial recommendation, which the Nortel board accepted, was the termination for cause of the CEO, the CFO, the Controller, and seven additional senior finance employees. In addition, the Wilmer Cutler Summary noted that "senior corporate officers, including the four Presidents of the business units during the period covered by this inquiry, the four Presidents of the regions, and the President of Global Operations, now recognize that inappropriate activity involving provisioning occurred 'on their watch.'" (p. 99). Going further, it stated:

> To demonstrate personal commitment to the governing principles stated above and to lead the Company forward, each of these officers has volunteered to return to the Company the entire [Return To Profitability] bonus that he or she was awarded, net of taxes already paid . . . (p.99).

As a result of the Wilmer Cutler investigation, senior managers, many who had spent their entire careers with Nortel, were subjected to humiliation and financial losses. For Dunn, Beatty, and Gollogly, there was also the expensive, time-consuming, and tortuous prosecution which ended with their acquittal. This raises the question about how Nortel directors dealt with the recommendations it received from

Wilmer Cutler. This is the final issue in regard to board's management of the investigation. The prescriptions provided were arguably strong, and the board stated:

> After thorough consideration, the Audit Committee has recommended, and the Board of Directors has approved, adoption of each of these recommendations. (Wilmer Cutler Summary, p. 101)

This wholesale acceptance of recommendations raises questions about directors' independent judgment and proportionality of response. The most sensitive issue was the termination "with cause" that Wilmer Cutler had recommended for Dunn and team. As pointed out, there is no indication that the question of legal liability was considered by Wilmer Cutler or that the recommendation was informed by the issue. These would be important considerations, especially when the directors were willing to act on the recommendation. By now, Dunn, Beatty, and Gollogly have been acquitted in the criminal trial, but in any case it is debatable whether their actions disclosed in the Wilmer Cutler Summary warranted or justified the strong response of termination with cause. How far this was considered by the directors in their decision to accept the Wilmer Cutler recommendation is an open question.

Leaving aside the merits of Dunn and team's termination, the manner in which it was done had an obviously negative effect on Nortel. It weakened the company. The subject is tied to the leadership and succession planning issues discussed earlier. The sensational terminations happened at a time when Nortel was weathering serious business challenges and slowly recovering from a massive downsizing. The adverse publicity the terminations received, impact on share price, uncertainty in the company and consequent erosion of trust among customers are some of the serious fallouts from the development.

Proportionality of response is another important issue. If the Wilmer Cutler report raised serious issues, a question is whether termination with cause was the only way for the board to deal with them? Or could it have made efforts to identify alternatives and come up with more nuanced responses that softened the blow for the company, while ensuring that the lessons learned from the investigation were duly applied? This is about balancing conflicting considerations and formulating optimal solutions, a skill which corporate boards with their matrices of expertise and experience are understood to possess and be able to apply. Binary approaches would hardly suffice in such situations.

Another issue is about the approach of external independent boards and their risk appetite/ aversion. From the standpoint of regulatory risk, the accounting investigation commissioned by Nortel board might be justifiable, but the management of the process and wholesale acceptance of the recommendations made by the investigating agency are more problematic. Again, board's acceptance of the recommendations could be rationalized from the regulatory risk perspective, but this must be

measured against factors such as negative impact on the company, directors' wish to be seen as doing the right thing and their exercise of independent, mature judgment.

An important consequence of the accounting investigation and its outcome was a series of class action lawsuits filed against Nortel. The company settled the lawsuits in 2005 at a cost of almost $2.5billion, as reported in the financial statements. Apart from the direct costs – namely, legal expenses and settlement, Nortel also suffered business damage from the suits. They prevented the company from pursuing valuable business opportunities it had identified. Potential partners declined to finalize the transactions citing the pendency of the suits and the resulting uncertainty about the costs Nortel might incur because of them.

4. Business Oversight and Bankruptcy Filing

Filing for bankruptcy protection in January 2009 was a major decision made by the Nortel board, the final one for practical purposes. The decision can be better understood in the context of Nortel's business results, which were indifferent over the last several years of the company's existence. To state the obvious, the basic function of a corporate enterprise is to manage its business in a profitable and sustainable manner, fostering the interests of stakeholders. Nortel's record on the business front was not impressive and a question is about the board's concern with the subject. This last section examines the bankruptcy filing against the background of Nortel's erratic business performance over several years and board oversight of business. Filing for bankruptcy in 2009 can be viewed as a culmination of Nortel's lacklustre business record over a long period of time.

Nortel's business results were unstable and the company was only sporadically profitable. This had been the case at least since 1996, which is the period covered in this study. The table below presents Nortel's business results, shareholders' equity, and long-term debt from 1996 to 2008. The figures are taken from annual reports, before any restatement. From the standpoint of board oversight, the original figures would be more relevant because they would have been placed before the directors on an ongoing basis.

Table 3

Nortel Financial Data, 1996-2008 (US$ millions)

	Revenue	Operating Earnings	Earnings before Taxes	Shareholders' Equity	Long-Term Debt
1996	12,847	1,080	944	4,876	1,663
1997	15,449	1,334	1,267	5,410	1,565
1998	17,575	-177	64	11,565	1,648
1999	22,217	354	526	12,518	1,624
2000	27,948	-2,429	-1,818	29,019	1,178
2001	17,511	-26,763	-27,559	4,824	4,094
2002	10,560	-3,804	-4,063	1,960	3,719
2003	10,193	45	281	3,945	3,891
2004	9,828	-111	-83	3,987	3,862
2005	10,523	-2,671	-2,586	786	2,439
2006	10,158	282	141	1,121	4,446
2007	9,654	226	270	2,758	3,816
2008	9,189	-2,182	-2,456	-3,951	4,501

Nortel had operating profits in six of the thirteen years since 1996. It ran up losses in the other seven years. In particular, asset impairments and goodwill write-downs of $17billion made in 2001-02 resulted in spectacular losses. Cumulatively, Nortel earned total profits of $3.3billion in the six positive years. Against this, its losses in the remaining seven years added up to over $38billion. If "goodwill impairment" and "other special charges", totaling $17billion, are excluded from this figure, it would still leave a loss of over $21billion. Over the thirteen years, the net result of operations was a loss of over $17billion before the special charges, or twice that figure if the special charges are included.

Shareholders' equity grew almost five-fold between 1996 and 2000. It climbed from about $5billion in 1996 to over $29bilion in 2000. The spurt resulted mainly from the shares Nortel issued in these years for the businesses it acquired. From 2001, there was a steep fall on account of losses and write-downs, with shareholders' equity hitting a low of just over $1billion in 2006. Some recovery was seen in 2007, with a rebound to $2.8billion. Finally in 2008 shareholders' equity tumbled into negative territory. This was followed by the bankruptcy filing in January 2009.

The issue to be considered is board's concern with the swings in Nortel's business results and shareholders' equity. Given the major themes in corporate governance –namely, director independence and monitoring, the framework can inherently discourage serious board engagement with the core issues of business performance and commercial soundness and sustainability of operations. Economic

theorists have argued that share prices and stock analysts would perform these functions and provide necessary correctives (see e.g. Jensen & Meckling 1976). The validity of the proposition must be weighed against evidence from cases such as Nortel.

At Nortel, erratic results persisted over several years and this raises issues about the quality of the strategic attention paid to the core business, which is essential for long-term sustainability and growth. To be fair, the board was not oblivious to the weaknesses in Nortel's performance. The directors were engaged with the cost-cutting exercises undertaken by CEOs Frank Dunn (2001-04) and Michael Zafirovski (2005-09). These initiatives were launched with broad support from the board, although their efficacy was questionable. In any case, it is debatable whether these measures amounted to statements of strategic vision or instruments for attaining that vision. They were *ad hoc* exercises, to a considerable extent.

The questions from the governance standpoint are about a role for directors in forging the strategic vision and providing guidance in achieving it. These issues would be especially relevant in a company with floundering business. Struggling business is evidence of weaknesses in management, and this would warrant directors to "step-up." In troubled companies facing challenges, a limited monitoring role for directors would be insufficient. These ideas inform the analysis below.

The unimpressive pattern in Nortel's business results over a decade indicates the logic in the directors' decision to file for bankruptcy protection in early 2009 – during the Credit Crisis. The situation was dire and the bankruptcy decision can be explained by several factors. Other than business problems, Nortel had endured special strains that left scars. These included the accounting investigation, churn in its leadership, and adverse publicity. Zafirovski had been brought in three years earlier to achieve a turnaround and there were problems between him and senior management (Bagnall, p. 46). Compounding internal troubles, the Credit Crisis had begun in late 2008 casting a pall of gloom. These were some circumstances in which the decision to file for bankruptcy protection was made.

According to reports, Nortel directors made the first move towards bankruptcy by hiring Ernst Young as advisors on September 26, 2008. Around the same time, they also enlisted Lazard Freres, an investment bank specializing in restructuring and Cleary Gottlieb, a law firm that Nortel regularly used in the US. The bankruptcy filing was done on January 14, 2009, based on advice the directors received from the expert agencies (Ottawa Citizen 31 Oct 2009[30]).

In law, there will probably be no interference with the decision of the directors. In essence, legal rules are not concerned with the correctness of business decisions or their outcomes. Rather, the rules focus on the procedures adopted and the "reasonableness" of decisions. In Nortel, the directors

engaged qualified advisors and acted according to the advice they received. The decision would likely be characterized as an exercise of "business judgment" and courts generally defer to the judgment of corporate actors in the absence of fraud or self-dealing. In dealing with challenges to corporate policies or actions, courts look for reasonable decisions, not perfect decisions (*Maple Leaf v Schneider* (1998)[31]). The legal standard is underpinned by a number of considerations, such as courts' lack of business expertise and inability to "second-guess" corporate decisions, and the fact that decisions are often challenged *ex post* with the benefit of hindsight. This is, more or less, the position in law.

Nortel's bankruptcy decision can take on a different complexion, however, from business and governance standpoints. From these perspectives, there could be issues not unlike those relating to the earlier decisions on the accounting investigation and complete acceptance of the recommendations of Wilmer Cutler. These include conservatism in approach, concern with perception, and potentially self-protection. The substantive question would be was bankruptcy filing, with its negative impact on morale, the only alternative? Or were any other options available? Also did the directors do the right thing in overriding CEO Zafirovski to decide in favor of bankruptcy filing?

Undeniably, Nortel was in a weak condition and the external environment had taken a plunge for the worse with the Credit Crisis. These arguments support the bankruptcy filing decision. But there could also be counter-arguments. The company had cash balances of over $2billion and there was no immediate crisis to be staved off. Whatever its other failings, Nortel had not borrowed excessively and there was no alarming rise in long-term debt through its last years as shown in Table 3 above. The board had to consider the arguments and counter-arguments, and make a judgment call.

It is significant that Nortel board hired Ernst Young as bankruptcy advisors on September 26, 2008. This was quite early in the Credit Crisis – ten days after the US government announced the bailout of American International Group (AIG), an event that signalled the arrival of the Crisis. The timing can be cited as indicating the conservative thinking in Nortel board. In late 2008 during the Credit Crisis, Nortel also made efforts to raise funds from the government of Canada (Bagnall, p. 79).

Collective decision-making is complex. It would be more so in a challenging setting like that of Nortel in 2008-2009. To deal with the challenges would require not just judgment, but possibly also some amount of pluck and a dash of entrepreneurialism. A bold entrepreneur who knew the business might have acted differently. Possibly, she might not have shied away from the challenges and been readier to stand her ground. By definition, corporate boards made up of external independent directors cannot be expected to act similarly. The dynamics would be different in the boardroom of a public corporation. Here, several factors would shape decision-making. Typically, these include the culture of

the individual board, the larger business culture in which the company operates, any expert advice received by the directors, and expectations about legal consequences. Another determinant would be directors' risk appetite/ aversion.

In Nortel, as stated earlier, it is possible to characterize the bankruptcy filing decision as a product of its board's conservatism and caution. These are, perhaps, features it shares with the earlier decisions on the accounting issue and Wilmer Cutler's recommendations. However, both decisions can be rationalized with the ideas stressed in corporate theory. Being external and independent, directors would lack in-depth knowledge of the company's business and this would place them somewhat at a handicap. As monitors, they would be logically concerned with perceptions about doing the "right thing." Entrepreneurial skills are not prominent among the qualities emphasized for corporate boards; some natural consequences of the trend would be risk aversion, preference for a line of less resistance and a concern for self-protection.

The actions taken by the Nortel board can make sense from the prism of directors as monitors. A caveat here is against treating the decisions as reflections on the individuals who made them. This is obvious from the fact that Nortel board consisted of different members in 2003-04 when it had to deal with the accounting issue, and 2008-09 when the bankruptcy issue was decided. Nortel board had 13 members in 2004 and 11 in 2008, but different sets of individuals sat on them at the two points in time. Though made up of different members, there were similarities in terms of matrix of skills and credentials of the directors. To some extent, these commonalities can explain the similarity in the approaches of the two boards with different members. Thus, it is apparent that the issue with boards is more deep-seated, going beyond individual directors. The experience points towards a level of homogeneity in the style of board functioning despite any nominal differences in composition. The problem can be traced, at least in part, to corporate theory and the general expectations about board responsibilities. It is apparent that monitoring boards, stressed in the corporate governance discourse, tend to be constrained and reticent.

There are some other issues with Nortel's bankruptcy filing decision. These are (a) the position of the advisors and (b) the absence of a plan of reorganization to be implemented under Chapter 11 of the US *Bankruptcy Code,*[32] and (c) complexity of multi-jurisdictional proceedings. Ernst Young, Lazard Freres, and Cleary Gottlieb, the professional firms that advised Nortel on the bankruptcy filing decision, were all subsequently engaged by Nortel to work on its bankruptcy case. They benefited from their advice to Nortel to file for bankruptcy protection, and this raises the issue about conflict of interests in the advice they provided.

The cost of Nortel's bankruptcy proceedings has been enormous. According to a recent estimate, professional fees of over $1billion have been paid (Financial Post 27 Nov 2013[33]). The issue has generated understandable concern; its poignancy is underscored by the fact that Nortel has not been able to meet its pension obligations to former employees of longstanding.

Presumably the firms that advised Nortel to opt for bankruptcy earned a portion of the fees, both for providing advice on bankruptcy filing and later for work related to court proceedings. If this were so, there would be conflicts of interests for the professional firms that were involved. The issue is relevant both for corporate governance and law, and practices here need fine-tuning.

Directors, in particular external part-time directors, often need advice from experts on complex issues connected with corporations – such as financial future and related safety measures. This explains the trend for boards to seek expert advice on specialized issues. Corporate law explicitly recognizes the practice and protects directors with regard to their duty of care, if they have relied on expert advice (*CBCA,* sections 122 and 123). The legitimacy of advice is undermined if experts have conflicting interests. This will likely cloud their judgment and detract from the objectivity of their advice. In Nortel, these questions are relevant for the firms that advised the directors on the bankruptcy filing and later earned fee from bankruptcy-related work. The experience underscores the need for ensuring the independence of experts and absence of conflict of interests in rendering advice.

The second issue is about the restructuring plan of Nortel, or the lack of it. Proceedings under Chapter 11 of the US *Bankruptcy Code* are designed to facilitate restructuring by debtors and return to financial health. The device is usually employed by cash-strapped companies deeply in debt. They can use Chapter 11 to renegotiate with creditors and bring debt to more manageable levels. The incentive for creditors is improving their chances and quantum of recovery if the debtor-company is able to continue in business, rather than close down and liquidate its assets. Chapter 11 involves a plan of reorganization under which the debt levels are reduced. The plan must be approved by creditors and court, and this paves the way for orderly restructuring. A major advantage of the Chapter 11 device is there is no interference with the control or management of debtor-companies. No receivers or trustees are appointed for debtors' property; directors and managers continue in control under the "Debtor-in-Possession" (DIP) rule. In substance, Chapter 11 offers protection from creditors and enables business operations during the time when debtors propose plans of reorganization and seek approval.

In Nortel's case, it is doubtful if the preconditions for Chapter 11 filing existed. With about $2.4billion in cash, the company was not quite illiquid. Nor did it have any steep increase in debt. Long-term debt remained in a narrow band of $3.8billion to $4.5billion between 2006 and 2008 as shown in

Table 3. It is also significant that Nortel did not also have a plan of reorganization of debt when it filed for protection under Chapter 11 in January 2009. It is not clear what level of preparation went into the filing. The company stated the following in its 2008 annual report filed in March 2009, two months after the bankruptcy filing:

> The Creditor Protection Proceedings will allow us to reassess our business strategy with a view to developing a comprehensive restructuring plan (p. 4).

The statement suggests that there was no such plan even in March 2009. To be clear, Chapter 11 is not an omnibus device for any kind of business restructuring. It is designed, essentially, for debt renegotiation and reduction. In 2009, Nortel was in the midst of restructuring of a different kind. Later in the 2008 annual report there are indications of the lack of clarity that prevailed on restructuring. The references included job cuts, putting on hold the sale of Metro Ether Networks and putting up for sale the Layer 4-7 Data Portfolio. The question is how Chapter 11 filing can help with such efforts.

Indeed for sale of assets, bankruptcy filings tend to be counterproductive. To begin with, bankruptcy proceeding of any kind weakens companies, undermining employee morale and customer confidence. The issue with asset sales is the impact bankruptcy filing has on potential buyers. They are likely to be tempted to wait out and hope for lower prices. Events happened along similar, predictable lines at Nortel. Metro Ether Networks (MEN) division had been put up for sale in September 2008, months before the bankruptcy filing for an asking price of over $2billion (Canadian Business 12 Oct 2009[34]). It was finally sold in bankruptcy in November 2009 for $769million (Light Reading 23 November 2009[35]). By this time, the division had also seen a slide in its revenue.

Chapter 11 can help in negotiating with creditors as it offers them a chance to improve their recovery. Creditors would be sensitive to the reality that with the other option, which is liquidation, they would probably be worse off; recovery would be more complicated and possibly in lesser amounts. Thus while Chapter 11 protection can be positive for debt renegotiation, it would probably be the opposite for sale of assets. These are some considerations that inform decisions to file for bankruptcy protection, and it is not clear how they were factored in the Nortel decision.

From Chapter 11 filing for protection, Nortel hurtled inevitably towards bankruptcy. With further declines in business, it announced in June 2009 that it had given up efforts to emerge from bankruptcy. On June 26, 2009 Nortel shares were delisted by stock exchanges.

A third issue with the Nortel bankruptcy filing is to do with the complexities of managing proceedings in multiple jurisdictions. Canada, US, and UK were the three major markets in which Nortel did business and, other than these, the company had presence in a number of other countries. The

bankruptcy filing in the US triggered similar proceedings in other jurisdictions. Proceedings in multiple jurisdictions created problems with the cash balances of Nortel which were scattered and could not be moved. Of the $2.4billion, only $841million was in North America with $176million in Canada. Claims in different parts of the world had to be settled. Earlier this year it was reported that US and Canadian judges will hold joint sessions in Delaware to hear claims from Nortel's creditors in North America, while claims in Europe, Africa, Middle East, and UK will be considered by arbitrators (Toronto Star 8 Mar 2013[36]). Obviously, all these add to the cost of bankruptcy proceedings which has emerged as yet another problem.

The issues outlined above raise questions about the preparation that went into the bankruptcy filing. Bankruptcy filing was first considered by Nortel board in September 2008 and the filing actually happened in January 2009. The intervening period of more than three months could have permitted better planning and preparation.

C. Lessons from Nortel

The story of Nortel is almost over except for a large number of former employees struggling to get their pension. If at all the Nortel episode offers any lessons in corporate governance, it is about rethinking the role of directors. The corporate culture in North America is essentially CEO-centric (see e.g. Rakesh Khurana 2004[37]). In the normal course when a corporation is doing well, its directors receive very little attention. But since at least 1935, the tendency has been to turn the focus on them when things go wrong (William Douglas 1935[38]). More recent evidence of the tendency is available in the Dey Report (1994) and the US Senate investigation of Enron (Enron 2002[39]).

Efforts for improvement must take the culture of CEOs and notions about their power into account. Given longstanding habits and traditions, it might be unrealistic to attempt to reengineer corporate governance towards a more collective structure (for a contrast in Germany, see Globe and Mail 6 Sep 2013[40]). The CEO-centric model is interesting because in corporate law, control is vested in a collective agency – namely, the board of directors. But in practice, leadership has veered towards a linear model with authority centralized in CEOs. The argument here is that it makes sense, like linear command does in military organizations (see e.g. Stephen Bainbridge 2002[41]). Unified command, rather than managing committees, enables better direction and quicker response for commercial enterprises operating in highly-competitive, global markets.

Arguably, now CEOs are not quite as powerful as they used to be in the 1960s and 1970s (see e.g. William Allen 2008[42]). Yet CEO power and its acceptance are undeniable. Therefore, it would be

more to the point to examine how a more meaningful role can be crafted for boards within the existing framework. In essence, this would involve the following:

i. Having a balance of executive and non-executive directors on boards: This can ensure the presence of a fair amount of inside knowledge in the boards, which can make boards stronger and more effective. This is about reducing the emphasis on independence as the criterion for directorship.
ii. Repositioning boards as stewards of corporations: The monitoring board model essentially limits the role of directors and can hamper their engagement with corporations. The importance of director engagement is increasingly accepted, and it would be more crucial in companies weathering business headwinds and other challenges, such as the churn in CEOs that Nortel experienced. The concept of stewardship would encourage directors to play a more expansive role. A criticism this can attract is that companies would become more bureaucratic as a result, but to some extent this can be countered by placing equal emphasis on board adaptability.
iii. Adaptive boards: The next issue is about the capability of boards to adapt to changing situations and circumstances. Boards can perform the more passive monitoring function during good times, but graduate to a more expansive role in difficult periods. The transition will largely justify the cost of having directors with impressive credentials and companies can look to them for efficient support and guidance in times of trouble. A more dynamic conception can also check the risk of bureaucratism that could result from greater board engagement and participation.
iv. Shareholder value and board monitoring: Share price increases in the stock market can be mesmerizing and they can encourage questionable policies and practices such as the massive expansion and acquisitions seen in Nortel. Shareholder value can also undermine board authority and discourage directors from questioning CEOs when share prices are on the ascent. The perils of shareholder value and short-termism are now better recognized. One way of countering the tendency would be to have a clearer definition of corporate goals that are focused on the substantive business and the product/service market in which companies operate, rather than share prices and the stock market. This can facilitate greater attention to business at all levels, including the board, and check the tendency to be swayed by share prices and events in the stock market.

For directors to be more effective, particularly in troubled companies, a first condition is having an appropriate definition of their position. Positioning directors as corporate stewards can produce a different outcome. It can encourage them to have deeper engagement and assume some responsibility for business outcomes. If notions about stewardship, rather than monitoring, shape the atmosphere in boardrooms, it can encourage greater engagement with core business, entrepreneurial flair, and the willingness to take risk.

The idea that boards must engage with corporate strategy is not new. It was recognized in the Dey Report (1994) and expanded in the Saucier Report (2004). Dey Report included adoption of corporate strategy among the responsibilities of boards, and the Saucier Report identified a broader set of board responsibilities for boards. These include setting the parameters on strategic planning and risk management. At the empirical level, the McKinsey Survey (2013) indicates rising board engagement with strategic planning and performance. The trend away from monitoring, pure and simple, is thus a fact.

A related issue is about having a larger presence of executive directors so boards have a blend of inside knowledge and outside expertise. The stress on independent directors can be traced to the Berle and Means' model of early twentieth century when boards mostly consisted of executives. Corporations were completely under the control of insiders, and in that setting passive retail investors, who were the nominal owners as shareholders, played no meaningful role. Independent directors were conceived as a check on the power of insiders. This origin also explains the emphasis on monitoring as the function of directors.

The notions appear adversarial and a tad archaic when corporations are conceived in more relational terms. The exaggerated emphasis on independent directors has left boards, the agency charged in law with ultimate responsibility, with little knowledge of corporations' business and limited capacity to provide meaningful leadership. In the matter of board composition, the pendulum has swung from one extreme of insider-dominated boards in early twentieth century to the other extreme of non-executive boards in recent decades. Evidence suggests that the better position lies, perhaps, somewhere in the middle.

A more nuanced framework of stewardship can accommodate within it the monitoring principle. In a company with effective management and stable business, directors can have a limited oversight role. But they must be able to calibrate their function depending on the situation. Boards will need to shift gears and become more engaged when times are challenging or there are leadership problems. This is about adaptive boards. A dynamic approach of this kind can help in reorienting board functions and equip them to better handle challenges and demands as they emerge.

The lessons offered by the Nortel episode can contribute to making corporate theory more wholesome and complete. In particular, corporate theory has not paid sufficient attention to the limited validity of the monitoring function. The approach has been mono-dimensional, with little sensitivity to the limitations of the monitoring principle. The Nortel episode demonstrates the need to expand and fine-tune corporate theory and role of directors to better serve current and emerging needs of business corporations operating in global markets.

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