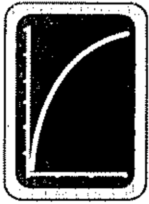

LEARNING CURVE®

To Hedge Or Not To Hedge, That Is The Fiduciary's Question

Most company directors know that they must act for the good of their companies. What many of them probably do not know, however, is that recent advances in financial technology may have driven the law to a point where directors are required to contemplate certain financial strategies. More specifically, structured finance today is so good at providing hedges for financial risks that directors might need to investigate hedging just to meet fiduciary obligations.

Directors Have Fiduciary Obligations

The challenge that hedging poses to directors begins with basic corporate law. In most developed legal systems, directors owe fiduciary obligations to their companies and sometimes to shareholders or other stakeholders. These obligations require directors to act or refrain from acting for the benefit of their charges. Also, and as part of or in addition to these obligations, the typical companies law imposes on directors a duty of care—that is, to be informed before taking or not talking action.

Because these deceptively simple legal standards are marked out only conceptually, the law's oversight of directors is inherently elastic. With regard to hedging—which to many has by now become synonymous with sensible management of financial risk—claimants have begun to figure that out. Around the world, lawsuits against directors for failure to hedge, while not yet common, are no longer unknown. For instance, a suit was recently brought in the U.K. against the external directors of **Equitable Life**, a life assurance firm, for failure to heed a recommendation to hedge interest rate risks.

Whatever the outcomes of failure to hedge suits, some lessons should already be learned: directors who have not even considered hedging will be relatively difficult to defend in claims for breach of fiduciary responsibilities, regardless of any business judgment defenses. The same goes for directors who have paid only lip service to an examination of hedging. Put another way, directors can either seriously investigate the management of financial risk or face legal risk.

Hedging Has Evolved Rapidly & Dramatically

Hedging, at its most elemental, is about protecting. More technically, it is engaging in a transaction that will generate a gain in the exact circumstances that will cause a loss due to an exposure elsewhere. Hedging thus is commonly thought to reduce holistic risk.

Exposures against which companies like to hedge are financial, with the classic ones being market risk and credit risk. Anytime someone transacts to receive or deliver money or goods in the future, the risk is inevitable that events external to the transaction will decrease the value or likelihood of the future transfer. Market risk is the chance that the market rate or price of something to be paid or delivered will deteriorate by the payment or delivery date. Credit risk is the possibility that a counterparty that must make payment or delivery will default due to insolvency.

Only a couple of decades ago, hedging was relatively uncommon because hedging instruments—market driven contracts that artificially transfer risk to otherwise disinterested parties—were relatively rare. For many technological reasons it was difficult to structure or obtain products that hedged the target risks well. Those who wanted to hedge market risks were constrained either to make do with the narrow array of products then available or—if they were sufficiently sophisticated and conditions permitted—to do so "naturally" (for example, by generating foreign currency profits with same-currency costs). Those who wanted to hedge credit risks were forced into time-worn, but ultimately limiting, collateral or set-off arrangements with the counterparty or guarantees by the counterparty's bank. Given the state of play in those days directors then could not have been expected to pay too much attention to hedging.

But times have changed, rapidly and dramatically. Recent and impressive advances in information science, financial know-how and document standardization have made contemporary hedge products—derivatives and structured debt and equity instruments—relatively precise and pervasive. Today, these products can be structured to match a variety of market exposures closely and to separate credit protection from the counterparties and their banks. As a result, access to third parties willing to take on financial risks has been blown open, risk transfer possibilities have surged and the products themselves have spread widely.

With so much hedging opportunity unleashed by the new products, many now instinctively consider it prudent for

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companies to hedge against financial risk. The rationale is that well-constructed hedging will dampen the uncertainty of not knowing which way a market will move or which counterparty will or will not maintain solvency. This, in turn, it is thought, will free a company to concentrate on operations—something that a company presumably controls.

Hedging, however, must be considered in context. A practical consideration is that hedge products are not free. They cost either money (a premium) or an opportunity for maximum gain (downside protection can be bought with upside limitation), as the risk transferee expects some form of compensation. Also, running hedges of financial positions is not commonly simple and can require significant attention and expertise. This can be especially so when the hedger is required to provide collateral, an often complicated process to manage. Additionally, hedging products themselves produce various forms of risk, such as the all-important credit risk of the counterparty.

Hedging can also be challenged conceptually. It could be said to be wasteful if it were used to flatten a short-term volatility that, in the long–run, proved not meaningful. More esoterically, it could be thought of as speculative because it arguably is founded on an anticipation of unfavorable developments. These approaches are not necessarily convincing, and might be somewhat counterintuitive, but the essential message that hedging might not serve the corporate mission should be taken seriously.

Directors Should Pay Attention

Whether hedging truly provides net enterprise value is an open question. The answer likely varies from scenario to scenario and can depend on a company's outlook, operations, exposures and costs, much of which can be unique. Nonetheless, combine the striking advances in financial risk management with the typical legal obligations of directors and you may have a requirement for directors to make actual and informed decisions about whether to hedge.

While there may—or may not—be good reasons for failure to hedge, there are far fewer good reasons for failure to consider hedging thoughtfully. It is true that hedging is sometimes regarded as exotic. That, however, fails to account for progress—today, the use of hedge products is almost commonplace. It also is true that hedging can be complex, but duty of care requires directors to defeat complexity with appropriate study.

Conceivably, directors might neglect inquiry into hedging opportunities if taking up these opportunities would work against shareholder interests. Some shareholders could prefer that their company not hedge because they are adequately diversified at their portfolio level or want exposure to the financial risks that the company naturally faces. Beware. A possible misalignment of shareholder and company or other stakeholder interests could place directors in jeopardy.

In jurisdictions where directors owe fiduciary obligations primarily to the company, shareholder preferences will not easily override company interests. In jurisdictions where directors' fiduciary obligations run significantly to shareholders as well, a tension between the welfare of shareholders and that of the company may well be exposed, with a resolution not necessarily predictable nor, for that matter, straightforward. Finally, in jurisdictions where directors of insolvent or near insolvent companies owe fiduciary obligations to creditors, shareholder interests can edge toward unimportant if insolvency conditions exist.

Risk management techniques have evolved quickly and spectacularly and directors need to adjust. It certainly is not a given that hedging financial risk is a fiduciary must—one can imagine many circumstances that justify a declination to hedge. But, it will be hard to endorse a failure by directors to consider hedging genuinely. Hedging is too significant and too available to pretend that it is not worth a good look.

This week's Learning Curve was written by Norman Menachem Feder, partner and head of the international department at the law firm of Caspi & Co. in Tel Aviv.