Why turnaround professionals are indispensable to directors and officers

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Much has been written on the subject but it remains a burning issue — the fiduciary duties of directors and officers during a corporation's periods of solvency, insolvency and that debatable period known as the "zone" or "vicinity" of insolvency.

I have advised many directors and officers over the past 30 years, but I have also sat where you sit — as a CEO and director of public reporting entities employing many thousands of employees and responsible to complex constituency groups. Aside from the legal definitions of duties, I have often found that if directors and officers act in the best interests of the corporation and not themselves — if they ask the difficult questions, hire the appropriate professionals and demand the data needed to make the best decision — then they will have acted in good faith demonstrating independence, care and loyalty to the corporation.

But aside from all the resources available to a board, what perspective can a turnaround professional bring to the discussion? And why should our opinions be solicited? What business environments do we normally work in that allow us to be both analytical and intuitive? And how can we assist the director and officer in avoiding the zone of insolvency?

How to avoid the zone

An experienced turnaround professional can contribute by recognizing the warning signs of financial distress. These will be flashing red long before a business reaches the zone — an area commonly defined as where the fair market value of the company's assets is exceeded by that of its liabilities; or where it is unable to pay its fixed obligations as they fall due in the ordinary course of running the business; or where the company has insufficient capital to finance future operations. And the ability to read these signs quickly and clearly will determine the success or failure of an enterprise.

Turnaround professionals are often retained just prior to the zone, or, at times, when the company is already in it. As a result of our many experiences, we have become adept at spotting the warning signs and acting with a sense of urgency, often protecting directors and officers from the pitfalls of operating within the vicinity of insolvency.

The value in retaining a turnaround professional early

While the idea might seem self-serving, directors and officers have never needed outside advice more so than today. Even when they believe they have reviewed all the options in making a critical decision, the input of turnaround professionals is essential in this highly litigious environment.

I am often asked the following questions by directors who want to pinpoint the signs of business distress:

- Where can I find these warning signs?
- Which should I see first?
- How could I have seen them sooner?

In reality, these signs are not always found in historical financial statements and it is not easy for outside directors to make the necessary observations when they only meet four times a year in the boardroom. But those on the inside live among them on a daily basis and the critical issue is to identify them long before distress has a chance to overtake the company. I am often retained after some of the threats have become all too apparent, although little has been done to address and reverse them.

The big three warning signs: customers, creditors and employees

The signs are present from one to three years before a company reaches the insolvency stage, so there is plenty of time to address them and avoid the zone. But they are not all evident in the company's financial statements, which is why it can make sense for the board to keep an ear to the ground by meeting at some of the group's operating locations. It can even be a good idea for outside directors, without attempting to manage the business, to talk to one of the company's big customers. To give a concrete example of this, I currently serve on the Board of Regents of a major university, and our policy is that one of our Regents should always be a recent graduate, so we can better understand what students (our customers) want. Of course it is not usually practical to have a customer on a corporate board, but their input (unfiltered) is very important — as are the views of suppliers and employees.

In today's business and legal environment, directors cannot just show up for a meeting in a nice setting, take input only from management and believe that they are finished with their duties until the next meeting. None of this is intended to pit outside directors against management, but one phrase sums up how they might approach their responsibilities: "When you think you've done enough, do a little more."

The internal reasons

There are many warning signs of corporate distress that arise from the internal workings and philosophy of a business. The following are some of the more common ones that I have witnessed in working with hundreds of clients.

- **Overexpansion** — the need to grow larger at any cost by expanding through acquisition into areas offering little synergy and where the business itself offers inadequate industry knowledge.
- **Inadequate business planning or none at all** — the idea that each year will be successful without the benefit of a budget or a "bottom-up" plan. One of the worst strategies seen in troubled companies is the "waterfall approach", where everything begins with an expected sales volume requiring additional overheads to achieve a growth number that often does not occur. In the meantime, management has invested in fixed infrastructure to achieve that unrealistic sales level. This is one of the most common signs.
- **Failure to change a strategy that is not achieving the desired results**. There are times when a board must insist that management change a course or be changed themselves. Turnaround professionals, by our nature, are change agents — or, at a minimum, advisors who can help a management team and a board to see things differently.
- **Poor asset management**. Whether a division, product or working capital, poor management of line activities results in excess or obsolete inventories and aged receivables. This sign should be seen early.
- **Overdependence on one client**. When a customer accounts for 25 per cent of a company's annual volumes, a warning sign is flashing and management must implement appropriate incentives to diversify the customer base. Apart from the obvious risk of being overexposed to the whims and business fortunes of a single client, there is also the question of negotiating power. For example, big retailers have been known to lure a supplier into plant expansion to handle increased volume — and then position themselves to set the terms and conditions going forward. At this stage, it is too late for the supplier to reduce its dependence on the customer as it has made the investment and needs the volume to absorb this increased overhead. To avoid this kind of vulnerability, boards should ensure they receive an analysis of customer volume and related accounts.
- **Poor pricing policies**. Either a company does not know the true costs of delivering its product or service and so cannot make a profit, or, as is customary, pricing is being driven by market forces and the company cannot compete. I strongly recommend that management assemble a pricing committee with input from marketing, sales, finance, purchasing and production. This will provide an insight into all the factors that must be considered when setting a policy.
- **Excessive leverage or funded debt**. This is usually due to poor operating results, excessive

expansion without planned returns on investment, or an overpriced acquisition.

- **Extended vendor payables**. If vendor credit terms are 30 days and the company is beyond 60 days, there is a cash-flow issue that must be addressed quickly.
- **Labor issues**. Long before a threat of disruption and strike action, there will be warning signs such as increased employee grievances, absenteeism, reduced productivity and quality-control issues. While outside directors are not in a position to spot such problems, they can ensure that management pays attention to its workers.
- **Poor internal controls, poor accounting systems and a management team that cannot operate in a leveraged environment**. Although management may be well versed in the company's industry, a highly leveraged business with limited resources provides a different challenge.

A common theme here is that all these problems can be avoided. They are the result of a management philosophy and, unfortunately, a board cannot see these signs in a current quarterly report. The warning signs will, though, be evident to a turnaround professional as we see them far too often. And if they are addressed early enough then the company can steer clear both of the zone and the attendant risks for directors and officers.

The external reasons

External threats to a company are often more difficult to navigate, but a good management team and a well-informed board can deal with them successfully. Here is a selection of the possible issues.

- Competitive changes, including offshore companies that can operate at lower labor rates.
- Economic factors, including recession, excessive inflation or deflation, interest rates and currency movements.
- Technology changes moving at warp speed.
- Social changes, including consumer lifestyles and attitudes, and "green" issues.
- Government constraints, including tax rates, legislation, cap and trade issues, and product safety.

These signs will not be unique to any one company. The director and officer cannot claim that the environment in which they operate is outside their control. After all, a competitor will be in the same situation. I have often been told by new clients that their problems all began with an economic downturn. But my take is this: "Recessions do not cause business failures — they identify them."

The turnaround professional offers a different perspective to the board of a company facing the zone. In addition to being an independent third-party assessor of unfiltered facts, we import a sense of urgency to the boardroom — a sense that "business as usual is over" and that change must be implemented soon. While much of what we do is reactive to a distressed situation, we not only have the experience to identify the warning signs but also to deal with them in a rational way, prioritizing the remedial steps. Knowing what to do is important — but knowing what to do first is more important.

None of this implies that a board should hand over all responsibilities to a turnaround professional, for it still has fiduciary duties. But the retention itself does at least represent a "good faith" effort to exercise that duty of care.

Assisting directors and officers while the company is in the zone

It is not uncommon for the turnaround professional to meet the board for the first time when the company is either in or very near the zone of insolvency. By its nature, the zone is a difficult environment to define and is often determined after the fact, but directors and officers must protect themselves from those who will pursue claims against them should the company either fail or, at the very least, return less than was expected to its constituencies. The threat of litigation to recover even unwarranted amounts can be personally very expensive.

In this environment, directors and officers need to act with caution and with the guidance of outside professionals. The steps they take at this stage will almost certainly be reviewed should the company seek to restructure in Chapter 11 or, worse, liquidate.

At this point it is worth providing a reminder of the fiduciary duties in all environments, but especially so if the company has fallen from a solvent state.

- **The duty of care** requires that directors and officers act with the same care that a prudent person would exercise in a similar position and circumstance.
- **The duty of loyalty** requires that directors and officers put the company's interests above their own.

- **The duty of good faith** requires directors and officers to study the impact of their actions and decisions on the company and to assess the potential risk.

That said, how can the turnaround professional assist at this stage? What value do we bring?

The roles of a turnaround professional

The assessor or independent third party

Having reviewed the warning signs above, it is likely the company is now losing market share and key employees, and likely suffering from negative cash-flow. Secured creditors are lowering lines of credit, or worse, the company is in default and an amendment to the loan agreement is required to assure funding needs. And vendors are refusing to ship without cash on delivery or cash in advance, or worse, they are threatening litigation to collect. The business is at crisis stage and remedial action is required, and so the first task of the turnaround professional — the independent third party — is to provide an "unfiltered" report of the facts.

Based on these findings, several options might be available for addressing the situation. Given that the company is now in the zone, it is important to understand all its obligations, including those on the Balance sheet (secured and unsecured creditors) as well as operating leases and other executory contracts that might be "off balance sheet". I also like to provide the board with a "hypothetical liquidation analysis" to highlight the priority of claims and any negotiating leverage the business might have with each group, and to outline the possibility of deleveraging the company without a judicial process.

The assessment should include the turnaround steps that can be taken to improve both operating results and cash-flow. At this point, the board should insist that the business is managed on a "cash basis", because while profits are important, it is cash profits that will be pivotal in rehabilitating the company. It is a turnaround professional's mantra that cash measures reality while accrual accounting often reflects judgment bias, and as part of this, directors and officers will need reliable and meaningful short-term cash projections so they can examine all the options for improving the business and maximizing value for stakeholders.

The assessment becomes the document on which directors and officers can rely in making the difficult decisions. It should be presented at a formal board meeting and include a discussion and conclusion on the viability of the company, because, even in the zone, options are available for rehabilitation.

The advisor

Once the assessment is presented and the board accepts a strategy, the turnaround professional should become a trusted advisor. In addition, I always insist that outside counsel be present for all discussions on the best course of action, because it is not unusual to recommend steps that are beyond the ordinary course. The best advice here is that any decision must be driven by stakeholder value, whether it is the elimination of a product line, the sale of an operating division, a reduction in staff or any other steps that appear out of the ordinary but are in the best interest of the company — in other words, a fiduciary duty. Together with outside counsel, the experienced turnaround professional is well qualified to provide the Board with the necessary guidance to maximize the company's value for its stakeholders.

At times, it is necessary to examine the Chapter 11 options as a means of rehabilitating and reorganizing the business. The turnaround professional understands the post-petition process and often assists in the preparation for the filing. Statistics support the contention that the most successful Chapter 11 outcomes are those that have been carefully planned. Here, it is important to understand future financing needs and whether debtor in possession (DIP) is available — and, if not, how long the company can operate on a cash collateral basis without diminishing its asset value and so risking liquidation. The turnaround professional can negotiate the DIP and be a key witness in convincing the court on this matter.

If the lender group is demanding liens on the company's assets or, if already secured, is seeking additional collateral, directors and officers must understand the consequences and impact on other stakeholders. The turnaround professional can advise on the solvency/insolvency status or, if retained after liens have been granted, assess actions to "lift" them if they were granted within the preference period.

The chief restructuring officer

If it is deemed appropriate, the turnaround professional is the ideal candidate to assume this position. While management might still oversee the daily business operations, the chief restructuring officer (CRO) will be the interface with the board, the stakeholders and the bankruptcy court. Should

the company sell all or some of its assets, the CRO will play a key role in negotiating the terms and conditions to maximize value for all the constituencies, so acting as a buffer for the board in meeting its fiduciary duties.

If it becomes necessary to replace top management, the CRO can step seamlessly into the CEO role. I once made this transition at a public company when our assessment uncovered a significant accounting fraud that placed the entire board at risk. Together with outside counsel, we discussed and advised on the options, and ultimately this client was successfully reorganized in Chapter 11 and the board did not face litigation.

The communicator

Directors and officers require someone with an independent and credible voice to speak to them, and so do the stakeholders. In a distressed situation, communication with all interested parties is essential to promote co-operation. In this respect, the turnaround professional should be supplying independent and reliable business and financial data to everyone, including the official creditors' committee and the court in a Chapter 11 setting.

The negotiator

I cannot imagine a situation where the turnaround professional is not part of the negotiating team when it comes to a restructuring of the company's obligations. Given our role as assessors and advisors to the board, we become a natural conduit for all parties. This is the main reason why directors and officers must retain a firm or individual that has no interest in investing in the company; the conclusions reached by the board will be viewed as tainted should it transpire that its advisors are not independent third parties.

I have negotiated on many issues for boards. In pre-petition or non-judicial settings, I have talked to labor, landlords and customers. Turnaround professionals are best placed to manage these affairs should the Board become uneasy with management's direction.

In Chapter 11 settings, I have found myself negotiating the terms and conditions for the retention of key employees on behalf of the board, and presenting these issues to the creditors' committee, trustee and the court. Independence is essential in obtaining bankruptcy court approval.

The witness

During the course of a Chapter 11 proceeding, court testimony on a myriad of issues will be required. While others might be called upon to give opinions on selected matters, the turnaround professional has the standing to discuss many business and financial issues, including the necessity of actions to be taken that are not considered ordinary business activities. These issues might include the termination of a business segment; the need to sell selected assets and to obtain reasonable recoveries for those assets; litigation issues that arise in Chapter 11; and, ultimately, the feasibility or reasonableness of your company's plan to exit the bankruptcy proceeding.

Should directors or officers find themselves in the unenviable position of having to defend their prior actions, the turnaround professional can be a valuable resource in presenting their efforts to carry out their fiduciary duties.

Conclusion

I have studied the reasons for business distress and failure for a generation, and I have learned and documented that companies do not fail overnight but over a three-year period. Even more important, however, is that the rate of failure is not linear but exponential. By year three, a company is failing at a rate far faster than in years one or two — which is why a board can benefit from seeking the advice of an experienced turnaround professional early, as the first warning signs appear. We are no longer viewed only as crisis managers — arriving when it is too late — but as professionals who can move from analysis to conclusion quickly and thoroughly enough to avoid the zone, preserve value and eliminate the risk of litigation against directors and officers.

So while this chapter has focused on how turnaround professionals can assist in times of distress, it should be apparent that boards can benefit from our presence long before the zone is reached. We do not replace lawyers or outside accountants, but rather instill a sense of urgency in spotting the warning signs and influencing "change management".

Finally, when a company has missed its most recent quarterly plan or budget, that is the first warning sign. At this point, directors and officers should consider what we can do for them to meet the challenges that lie ahead.