10 Things Every Officer and Director Should Know about Operating a Troubled Company

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Business leaders are often too slow to recognize a trend, and therefore too slow to make the critical changes necessary to avoid operating losses. Such hesitation is natural, especially for entrepreneurs. When sales are off for a quarter, an optimistic entrepreneur might blame the sales organization or believe the customer who says its "buy decision" has simply been delayed. The seasoned business owner might adopt the view that "this is just a blip," because recognizing that this is a downturn would mean implementing a painful layoff. But in the meantime, the company fails to cut costs in the face of declining revenues.

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In short, most CEOs and board members of troubled companies don't recognize that the company is truly distressed until there is some "trigger" event—such as a covenant default, the loss of a major contract or a failed attempt to refinance. In happier times (as recently as 2007), such an event would typically signal the start of a 12-month forbearance period, during which time the company's lender would be willing to allow the company to restructure or sell off assets in order to improve performance or pay down debt. Not so today. In the current market, many creditors are themselves under tremendous pressure and will act quickly to mitigate losses.

The Trigger Event

In what seems like an instant, the rules of corporate finance have changed. The cost of capital has skyrocketed, and the availability of capital for marginal performers has all but disappeared. Equity capital is more expensive as well, as venture funds have seen their liquidity horizons extended to 2010 and beyond. Buy-out firms, which began to feel the effects of tightening credit in 2007, have now seen the leveraged loan market all but evaporate in recent weeks. Rather than write new corporate loans at 7 percent, many lenders are deploying their capital by acquiring loans from distressed lenders on the secondary market. Given the huge discounts being paid on these loans, the implied interest rates for "first out" loans trading in the secondary market have ballooned to 18-23 percent.

There is a growing consensus among corporate executives that the current financial crisis will have a significant and continuing impact on the availability of new capital for business. Many companies that were planning to raise new capital in the fourth quarter of 2008, or in the new year, will find that capital is no longer available, or if it is available, the next round of equity will more likely be dilutive. Companies that have operated for years with a line of credit or favorable equipment finance terms will find that when their financing comes up for renewal, there will be fewer lenders interested in extending them credit, and the cost of capital has gone up significantly.

About the Author

Jamie Grant heads the Mirus Special Situations Group and has been actively advising distressed companies on corporate financing options since 1997. An expert on distressed M&A, financial restructuring and buy-outs, he is often an expert witness on the valuation of companies and intellectual property.

Feature

The List

While every situation is different, we have endeavored to come up with a list that is instructive, rather than comprehensive, in order to persuade decision-makers that once the company is distressed, they need to begin operating by a different set of assumptions. Thus, what follows is our list of the top 10 things that every "troubled company" CEO and board member should know.

Understand "the Zone of Insolvency"

In approximately half of all chapter 11 cases, the directors and officers of the debtor company are sued for breach of fiduciary responsibility. Why? Because, under the Bankruptcy Code, there exists a conceptual moment in time at which the board's fiduciary duty shifts from maximization of return to shareholders to preservation of assets for the benefit of creditors. In most cases, the directors and officers don't realize the company has entered this "zone of insolvency" until they have already made several significant decisions—which, in hindsight, they would like to reconsider.

According to the American Bar Association, there remains some dispute as to whether a director's duties actually shift *from* a duty to shareholders *to* a duty to creditors, or if the scope of that duty merely expands to include creditors, or if a duty is in fact owed to all "creditor-like" entities (which would include employees, customers who have made deposits, etc.). There are also competing theories on just what the criteria are that determine the point at which a debtor has entered the zone.

What is for certain is that in the event the company's financial distress ultimately leads to bankruptcy, consideration will be given to the question of "when did the company enter the zone?" Further consideration will be given to the question of whether the directors and officers, once "in the zone," acted in the best interest of all stakeholders, including creditors.

A cautionary example would be the CEO that refused to cut staff and expenses and thereby continued to operate at a loss because he expected to close on a new round of equity investment. When that new round didn't close, the CEO (or the board of directors) might later be accused of "deepening the insolvency" at the expense of the creditors and may be found to be in breach of their fiduciary responsibility. It is for this reason that when it becomes evident that the company is in the zone, the last act of the board of directors is to approve the expenditure of company funds to purchase a tail on the D&O policy. Such vote is then promptly followed by the resignation of several—or all—of the board members.

Beware of Conflicts of Interest

Any company that has more than one stakeholder (whether they be shareholders, creditors, etc.) needs to consider the potential impact of conflicts of interest on decision-making. One common example is found in the venture-backed company. Venture capitalists wear two hats when serving on the boards of companies they invest in. As a company director, they have a fiduciary responsibility to the shareholders of the company and, in certain situations, to the creditors of the company. However, that same director is a general partner in a venture fund, and also has a fiduciary responsibility to its limited partners. In a distressed situation, the "best interest" of the company's creditors (to whom the directors would owe a fiduciary duty) will often be at odds with those of the venture capital investors.

Consult Specialized Insolvency Counsel

You wouldn't ask your family doctor to perform brain surgery, so don't depend on your corporate attorney for advice on insolvency matters. Ask your attorney if the firm has an insolvency professional that is experienced in debtor's rights. Just as you might use a specialist for an IPO, it is equally important to hire a specialist for advice on insolvency matters. Not all law firms have such a practice, so it is critical that you hire a professional that is experienced in representing the company's interest with respect to negotiating with creditors, filing for bankruptcy if and when appropriate, using the threat of bankruptcy to resolve disputes with landlords and other creditors, and all of the other unhappy circumstances that might accompany corporate insolvency. In many cases, your corporate attorney will give you this advice directly, and will bring in an expert from outside the firm if necessary to represent the company's interests.

Consider Personal Guarantees

If an officer or shareholder of the company has given a personal guarantee on a bank loan, a lease or even a credit card agreement, he or she may be on the hook personally in the event the company is unable to pay.

Understand Your WARN Act Liability

The Worker Adjustment and Retraining Notification (WARN) Act protects employees by requiring most employers with 100 or more employees to provide 60 calendar-day advance notification of plant closings and mass layoffs of employees. Employees entitled to notice under the WARN Act include managers and supervisors, hourly wage and salaried workers. The WARN Act requires that notice also be given to employees' representatives (*i.e.*, a labor union), the local chief elected official (*i.e.*, the mayor) and the state. The purpose of the advance notice is to give workers transition time to seek and obtain other employment, avoid homelessness, etc. If adequate notice is not given, then the company can be held responsible for paying equivalent wages for the notice period, and if the company can't pay, then the directors and officers of the company can be held personally liable.

Don't Overpromise to Your Vendors

Businesses in distress will often lean on their vendors to fund working capital. Taking liberties with the credit terms and stretching payments out is all fair game, but as the company's financial situation erodes, the vendors will eventually call and ask "Why hasn't this invoice been paid?," "When will this invoice be paid?" and, "Why should we continue to ship to you?" Be careful what your people are telling your trade creditors, because making false statements to obtain further credit (even for one last shipment) can result in personal liability and, in some cases, criminal charges against the officers (or employees) involved.

Avoid Using Credit to Fund Operating Losses

In recent months, several institutional investors have advised their operating managers to draw down their existing lines of credit in order to have cash available for 2009. The fundamental reality behind this advice is that new capital will be hard to come by in the coming year. This advice is flawed in two ways. First, it is not wise to fund operating losses with debt, unless it is a seasonal business or the losses are otherwise predictable and short-term. Second, most loan agreements contemplate a "control of cash" provision, which prohibits the company from taking the cash out of the business and placing it in a third-party account. Therefore, in the case of a default, the lender has the ability to "sweep" the company's cash—so drawing down the line doesn't buy you very much. Unless the company draws down the credit facility and deposits the cash in an account that is outside the control of the lender (meaning a CD or cash account at another financial institution), then this maneuver is unlikely to achieve anything more than higher interest expense.

Keep Some Powder Dry in the Event of the "Worst Case" Scenario

Don't make the mistake of waiting until the checking account runs out to shut the doors. Plan ahead for all of the wind-down costs, such as paying employees accrued wages (including accrued paid time off, as well as commissions and bonuses), employee expense reports, payroll taxes and the administrative costs of the controller or third-party professional that will pay the final bills and hand over the keys to the landlord. Depending on the state(s) in which your business has operations, officers and directors can be personally liable for unpaid wages, taxes and other expenses if not handled properly.

Bankruptcy Isn't a Death Knell, but Nor Is It a Panacea

The bankruptcy process, like root canal surgery, serves a useful purpose for many companies. But it is also painful, expensive and best to be avoided. After such major bankruptcy filings as Delphi Corp. and K-Mart, bankruptcy is no longer considered entirely taboo. For companies in certain industries, bankruptcy (or the threat of bankruptcy) provides valuable leverage when it becomes necessary to renegotiate certain agreements—such as leases and labor contracts. This is why so many retail chains, airlines and automotive suppliers have been restructured in the bankruptcy courts. However, for certain companies, the bankruptcy process offers little more than a vacation from the company's creditors. For professional services companies, financial institutions and start-ups, the stigma of a bankruptcy filing may also result in mass defections of customers: Witness what happened to Bear Stearns when the potential of bankruptcy was only a rumor.

Understand What Constitutes a "Preference" and What Sorts of Payments Might Be Disgorged in the Event of a Bankruptcy

A payment made to any creditor in the 90-day period before a debtor files bankruptcy (or within one year if that creditor was an "insider") that gives the creditor more than the creditor would receive in the debtor's bankruptcy case may be characterized after the fact as a "preference." Examples include management stay bonuses paid prior to filing and even employee bonuses paid as many as 12 months before filing, etc. Further, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) severely limits the administrative priority

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claims for certain types of executive compensation and severance in the event of bankruptcy. Specifically, BAPCPA prohibits a company from providing any retention or severance benefit to an executive unless, among other things, the executive already has a competing job offer in hand. The once-common practice of funding a cash reserve for management "stay bonuses" prior to a bankruptcy filing is no longer an option.

If Any of This Rings a Bell...

So now that we have your attention, you may be wondering, "why do I need this hassle?" or "should I just resign?" Both are good questions with no easy answer. However, many if not most troubled companies can be saved with skilled management. If you feel that your management team may be overmatched for the task at hand, professional advisors abound that can help with downsizing, outsourcing, implementing lean manufacturing methods, negotiating settlements with lenders and creditors, and more. Finally, chapter 11 isn't the worst thing that can happen. The fact of the matter is that many companies are over-leveraged, and if your business is one of them, then bankruptcy may in fact be the best solution. There will be hundreds of companies (many with household names) that will file for chapter 11 in the coming months. ■

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