Financial Advisory Panel: Curing the Cause and Not Just Treating the Symptoms — How to Fix the Business Issues and Not Just Adjust the Balance Sheet

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Implementing the Turnaround

The Operational Assessment is complete. You are done peeling the onion. You have identified the root cause(s) problems and have developed root cause corrective actions. The next step is to establish the specific actions need to be taken, assign accountability for the implementation of each action and create a timeline that allows for the implementation of the turnaround consistent with the level of liquidity available to implement the plan.

Commit the plan to writing. It can be a white paper, it can be a powerpoint or it can be handwritten on construction paper. The important considerations are adequate detail and distribution to all of the constituencies needed to execute the turnaround. The turnaround process is very fluid and while not necessarily complicated, it is generally very detailed. The turnaround process will also likely have tight timeframes driven in large part by diminished liquidity levels. These factors require that the plan be reduce to written form to prevent any confusion about tasks, deadlines and accountability among the parties responsible for its implementation. Who needs to receive the written turnaround document, or portions of it, will be driven by the specific facts and circumstances of your situation but potential constituents can include vendors, customers, lenders, equity holders, regulatory agencies, employees.

The next step is to establish how the turnaround will be monitored and measured. Measure what is important – that will drive the process and test the effectiveness of the root cause corrective actions upon which the plan is built. Everyone with responsibility for implementing the turnaround should receive a periodic scorecard which tracks the key metrics. Those closest to the implementation may choose to track additional, more granular information.

Your turnaround plan should contain some basic overall concepts. They are:

1. Don’t rely on sales growth to drive the turnaround. It’s the only line on the P&L you can’t control.
2. Aggressive Hands-on Management. Someone needs to be visible at the company to lead the turnaround process. It can’t be done by email, teleconference or video conference. The leader(s) can be members of management or the chief restructuring officer or the financial advisor/turnaround consultant. If these people aren’t visible then the thinking goes, “if its not important enough for them to be here, why am I killing myself?” It’s just human nature.
3. Instill a Sense of Urgency Mentality. Management or the turnaround consultant need to create a sense of urgency environment. The company needs to “hum” again. Everyone needs to have a sense of purpose and a drive to move quickly toward the stated goals. Tomorrow is too late.
4. Instill a Continuous Improvement Mindset. The turnaround will require everyone to look at things differently, question the status quo, be looking for incremental improvements. If you see an inefficiency, fix it. “If you see something, say something”. Employees should feel that this is a time where suggestions can have a real and immediate impact.

Once the turnaround has taken hold and the crisis has passed, these four concepts should continue on and become core principals and core competencies of the organization.

An integral part of the turnaround plan will be the financial projections. This is your GPS. The projections are a natural by –product of the Operational Assessment. They should be adequately detailed to allow management and everyone involved in the turnaround to assess their efforts and if changes need to be made. Most turnaround situations are challenged by poor liquidity. While GAAP income is important, the projections should focus on the real cash flow in and out of the company and the effects it may have on borrowing relationships. This will require forecasting both balance sheet and P&L activity to capture the true cash movements. A monthly forecast should be supplemented by a detailed 13 week cash flow that ties into the monthly forecast.

Measure your actual performance to your projected performance. High level reviews of financial performance are no longer acceptable. The financial group and the operations group must dig into the details so everyone can understand what is driving variances. If your actual performance becomes significantly behind plan, it's time to update the operational assessment and turnaround plan. There is no shame in starting wrong, but there is shame in staying wrong.

If turning around a business was only about solving the problems we wouldn't have much to discuss in this presentation. Forming strategy is easy relative to implementing the turnaround plan. The difference between strategy and implementation is people. People effect change. People also resist change. Now is the time to make a critical assessment of the management team. The key question to ask yourself: can this management team lead the turnaround. It takes a very different set of skills and a very different personality to turnaround a struggling business vs managing in a stable or growing environment. The chart below highlights the difference in skills needed:

Stable/Growing	**Turnaround**
Business Development	Firing bad customers
Designing New Products	Cultural Change
Certain stable environment	fear, anxiety, uncertainty, constant change
Adding Staff	RIF
Training	Behavior Modification
Concensus building	Confrontation

Don't be surprised if you find that some or all of the management team are not the best choice for the tasks at hand. Turnarounds are difficult and for most people, not fun. Again, human nature comes into play. People generally shy away from confrontation and tasks which are not fun and avoid change if possible. In tense and uncertain situations many people retreat to their comfort zone. In some cases you may have a successful CEO who has had a series of successes in building businesses and this could be their first encounter with failure. Failure is very difficult for an ego to handle and could result in behavior which hinders the implementation of the turnaround.

There is also the issue of emotional attachment. The management team or portions of it may have started the company, they may have had a part in developing a failed strategy, or they may have be part of making a series of bad decisions that have put the company in its current distressed state. These people may have a difficult time admitting they made a mistake and changes need to be made. If these are otherwise good managers it can be very helpful to introduce an experience turnaround consultant to lead the turnaround. When the situation has stabilized and begun to evidence positive trends perhaps the management team can return to running the business.

Finally, management may have trouble starting the turnaround process because they are unsure how to chart a path from underperformance back to where the company was before the decline. They are looking for the perfect strategy. You don't need to know what perfect looks like. You just need to know what better looks like.

By this point you have developed the turnaround plan, forecasted the financial resource and projected performance, assessed management, committed the plan to writing. Communication is the next big issue to address. This includes both internal and external communication. The progress of the turnaround must be communicated in a timely manner and in enough detail so that everyone can feel that they are getting the complete story to allows them to make informed decisions. You need to communicate both the positive and the negative. The people involved in the turnaround can handle bad news. What they don't want is surprises. If you fail to communicate or communicate fully, in the absence of information people will fill in the silence with the worst possible outcome they can imagine. Turnaround situations create fear, anxiety, stress and worry. It's just human nature to assume the worst because, "if something good was happening they would have told us".

Timely and full communication will help you build the credibility necessary to have the time required to implement the turnaround. Communication can include a variety of constituents such as lenders, vendors, customers, employees, etc. Establishing a periodic method for communicating is a key element to a successful turnaround. Different constituents will have different requirements in terms of timing and information required. Be sure to establish a schedule and stick to it. It is always better to over communicate. The transparency this creates helps to build creditability and patience.

Internal communication is something that should not be overlooked . Often internal "silos" have developed and departments operate without any knowledge of what is happening in other functional areas. The success of turnarounds can be hindered when functional areas are operating in vacuum and not fully understanding the effects of their actions on the turnaround plan or how they impact other areas ability to implement the plan.

I. Key Considerations When Deciding to File for Chapter 11 or to Pursue an Out-of-Court Workout

There are many considerations that go into deciding whether to file for Chapter 11 or pursue an out-of-court workout. Some of the most important ones to be evaluated by the company and its advisors include: (i) the need for a regimented framework or more flexibility depending on the process; (ii) the varying degrees of disclosure that may be required by either process and how that will affect the business from both time and cost perspectives; (iii) the potential impact on the company's public image and vendor/supplier base of a bankruptcy versus and out-of-court workout; and (iv) the amount of time that will be devoted to either process and associated fees and costs.

Bankruptcy

One of the biggest benefits of filing for bankruptcy is a fixed framework within which a company can restructure its debt and reorganize its assets. While this forum may diminish the owner's/management's control over the company, there is a generalized and set path that must be followed with benchmarks and timeframes. Within this construct the company can potentially resolve all of its financial and operational problems (or at least that should be the goal). Moreover, if the company can be successfully reorganized, then at the end of the day, the order of confirmation will bind all creditors, regardless of whether they vote in favor of the plan. As a result, bankruptcy can be a more streamlined process compared to out-of-court workouts.

However, to get to the end result, there is the concomitant requirement that a debtor, essentially living in "a fish bowl", must provide full and complete disclosure to its creditors of all of its assets and liabilities. These disclosure requirements can be burdensome in terms of time and resources depending upon the nature and size of the company's business. Not only are there the initial papers involved in the filing, *i.e.* the first day affidavit, the petition and schedules as well as the statement of financial affairs, but there will also be monthly operating reports and eventually spreadsheets and financial analyses to support any plan and disclosure statement. Completing these disclosure requirements will require countless hours from the company, its employees, outside counsel and potentially outside turnaround firms, all of which will cause the debtor to incur additional fees and expenses. In addition, claims and noticing agents, public relation firms, financial advisors, and committee counsel may also need to be retained and paid.

Not only are disclosure requirements burdensome, but they may force a company to reveal otherwise private or confidential business information. This has proven to be an important consideration for companies who may want to avoid public disclosure of their business information. It is not easy to obtain orders preventing this public disclosure, and it certainly is not easy to prevent members of the key creditor constituencies, which may include competitors from accessing it. Therefore, a company should weigh carefully this risk and/or concern outweighs the benefits of Chapter 11 depending on the company's industry of business.

Bankruptcy can also have a negative impact. While the use of bankruptcy as a tool in a company's arsenal has become more accepted and recognized, there can still be consequences. Depending upon the industry bankruptcy may have more of an impact on a company's reputation than for companies in other industries. Further, the bankruptcy filing may lead to constraints being placed upon the company's ability to secure goods if vendors or suppliers insist on "COD" at a time when cash is constrained. Customers who may be concerned about having their supply stream disrupted in the event of an unsuccessful filing may turn to competitors. There may also be an impact on the morale of the company if employees become concerned about their own future and job stability. While many of these issues can be addressed by filing critical vendor motions, key employee retention plan ("KERP") motions or the like, there are costs and risks associated with all of these options that should of course be evaluated.

As noted above, a bankruptcy can become a costly process and, if there are significant fights with creditors, it may become long and drawn out. Confirming a bankruptcy plan is not necessarily simple: the more complex the industry, the more varied or complicated the debt structure or the key issues, then the more involved the process may become. At the end of the day, nothing will happen absent full disclosure and adequate notice to the creditor body of the proposed plan. (Adequate notice may vary widely under the facts and circumstances of each case). In evaluating one option over the other, turnaround professionals and advisors should keep in mind that nothing out of the ordinary will (or should) happen in a bankruptcy case without the approval of the court, and/or creditor "buy-in".

There are some additional benefits in filing for bankruptcy as opposed to pursuing an out-of-court workout. For example, upon the filing of a bankruptcy petition, creditors are prohibited from taking any actions to enforce their legal rights or remedies against the debtor, or its assets, without prior permission of the bankruptcy court. This freeze on all activity gives a debtor breathing room to regroup and reassess where the business stands, and determine what steps might be necessary to salvage the company. Unlike out-of-court workouts, the Bankruptcy Code allows the *status quo* to be maintained without the fear of the depletion of the debtor's assets prior to any attempt to reorganize or fix the debtor's problems.

Furthermore, the Bankruptcy Code affords the debtor-in-possession broad powers to avoid or unwind certain transactions thereby returning those assets to the estate or freeing them up from liens. Many companies use the filing of a bankruptcy to strip an untimely lien obtained within a preference period in order to better utilize assets to save the company. Other companies have filed bankruptcy to secure the return of payments made within those time frames for the same purpose. If used strategically, this can be a real benefit to a company having financial issues.

In addition, Section 365 of the Bankruptcy Code gives the debtor the ability to reject, assume, or assign executory contracts. The ability to avoid the ongoing obligations of a contract is unique to the Bankruptcy Code and can be a critical tool in the debtor's arsenal. Section 365 allows the debtor to reevaluate contracts which may no longer be economically sound and reduce those contracts to monetary claims. This process is valuable because it allows the debtor to avoid the impact of a lawsuit over a breach of contract or specific performance while possibly maximizing the value of an asset. If certain assets are no longer needed by the company, then, through bankruptcy, they can be sold to a third party to bring additional value to the estate. This is something that cannot be done outside of bankruptcy absent permission of the other party to the contract.

Finally, if the company cannot be reorganized or if a sale was the goal from the start, bankruptcy provides a tremendous benefit: the ability to provide a buyer with a "free and clear order" under Section 363 of the Bankruptcy Code. Many purchasers will in fact insist upon this protection especially where a company is in financial trouble and may have pending suits or potential claims that could impact the sale in the ordinary course outside of bankruptcy. With a "free and clear" order, any potential claims and risks in a sale process can be put to bed and a purchaser has comfort in this. Of course, such sales are subject to higher and better offers, but because the results should lead to the highest (or best) value, then that should not be the company's direct concern. Rather, its concern should be whether the bankruptcy filing will deflate the price or whether purchasers may be looking to "kick the tires". The end concern should be whether the bankruptcy process will cause the debtor to receive less than reasonable value or fair market value for the estate such that the estate is not diminished and creditors can be paid a return. If bankruptcy will result in a fire sale, then companies must carefully evaluate whether Chapter 11 is appropriate.

Out-of-Court Workout

In comparison to the framework set by the Bankruptcy Code, an out-of-court workout has no specific structure. Rather, the process will be dictated by the number of creditors involved and the ability to swiftly negotiate and bring creditors to a consensus. To some extent, this option provides the board of directors with the strongest ability to maintain control over the process. Here, the company will be relieved of the burden of bankruptcy's mandatory disclosures, the eye of the Office of the United States Trustee and the Court. Thus, the only disclosures that will be required are those that the creditors seek or request. As such, some level of disclosure must still be provided to the creditor body, as no creditors will buy in to the process without some information; however, in most cases it will not be as extensive as the disclosures in bankruptcy. As this disclosure can be controlled by non-disclosure agreements, the information certainly will not be in the public eye or readily available on the internet.

Of course whether an out-of-court workout will be more streamlined still depends upon the number of creditors and the issues that a company must address. If there are a significant number of creditors, many of whom are difficult to work with or secure cooperation from, then the bankruptcy process may be more appealing in the end, because the class system provided by

Section 1129 will make this process easier. Further, the absence of a centralized forum can be either a positive or a negative. Since there is no "governing body" in an out-of-court workout, there is no centralized forum or final arbiter to make a decision or corral the creditors. Thus, it is entirely up to the company to contact and negotiate with each creditor. The only way an out-of-court workout is successful is if the company and its creditors are able to find mutual ground and negotiations are successful. Therefore, workouts require very high percentages of creditor cooperation and participation. If the negotiations stall or if creditors are recalcitrant, then out-of-court workouts can drag on and can be just as costly as a bankruptcy.

One of the greatest downsides of an out-of-court workout is the loss of the protections provided by the automatic stay in bankruptcy. In an out-of-court workout, absent a formal or informal forbearance agreement, if the company is in default, the creditors, secured or unsecured, are free to exercise any and all legal remedies they have to obtain redress against the company. This can translate into a "race to the courthouse" where each creditor is attempting to recoup as many assets as it can. This can also leave the company in a position to attempt to fend off multiple suits in multiple forums, while at the same time trying to keep the company afloat. Thus, this is an important consideration in terms of the ability to have reasonable time to focus and negotiate with creditors. Further, keep in mind that creditors can always join together and force the company into an involuntary bankruptcy.

Finally, in an out-of-court workout the company's ability to alter its obligations is first and foremost governed by the contracts that have been entered into with the creditors; those are only modified by agreement of the party. Unless in bankruptcy, a company cannot simply file a motion to reject an agreement, or assume and assign to a third party. A company needs consent of the other party in order to make this valuable. Otherwise, breach leads to a suit and claims and assumption/assignment will be most likely forestalled or blocked by suit as well.

II. <u>Important Factors to Consider in Making a Decision</u>

First and foremost, it is important to consider whether the company is currently in default of any obligations or merely anticipates default. This is important because depending upon the status of the company's obligations, the decision regarding whether to choose to file for protection under Chapter 11 or an out-of-court workout may already be out of the hands of the company. For example, if the company is already in default and there is a pending application for relief in court that will affect the company's operations (such as order of seizures, injunctive relief or a judgment entered), then the company may have a limited window to file for bankruptcy in order to retain control of its assets. As such, there may no longer be a window of time for an out-of-court workout.

Determining the company's current status should include an evaluation of the company's cash flow, current liquidity, the value of the company's current assets/collateral, (and whether a sale of some or all of the company's assets can be pursued) and financial projections including economic and industry forecasts. A company should also consider whether any recent transfers or liens would be subject to avoidance that would free up assets. If so, this could free up assets to fund a bankruptcy plan. The company should also consider if the company could benefit from the rejection, assumption and assignment provisions of Section 365. If there are any unfavorable contracts or leases that are overdue, bankruptcy may be a better option than an out-of-court workout because, as indicated above, bankruptcy will allow the company to reject them and monetize them into a potential unsecured claim that will be paid a percentage of the claim. Moreover, under-utilized agreements may have a market value that can be capitalized in bankruptcy. Of course, if the company files for bankruptcy, depending upon the type of agreement, then the company may have a limited window to make decisions on leases and other contracts.

After determining the company's current status, it is incredibly important to consider the cause of the company's financial problems. Is the company's financial situation due to a onetime event or is it based off of a problem with the business model? Was there a significant change of needs in the industry or market place? It is important to remember that filing for bankruptcy cannot fix a broken business model. Thus, it is important to ask: if there is still a need for this business; what the business provides in the market place; if the business can still be profitable if the problems can be fixed; or if it is just a waste of time and good money is being thrown after bad.

After a thorough evaluation of the company's current status, a company should consider whether there is a reasonable prospect for solving the company's problems outside of bankruptcy. In order to determine whether an out-of-court workout is plausible, the company should consider the size of the creditor group involved, whether the company has something it can offer to creditors (money and/or ongoing business relationships), and whether there are any significant creditors (or groups of creditors) without whose support a workout will not be successful. As stated earlier, out-of-court workouts require a high percentage of creditor cooperation. Therefore, an out-of-court workout is extremely difficult if the size of the creditor group is so large that either, the company or its advisors will have a hard time contacting creditors, or creditors have a hard time finding an area of mutual interest.

However, if the creditor group affected is smaller or perhaps more concise in type and structure, it may be easier for the company to negotiate and convince all of the creditors to agree. In addition, if the company has one or two larger creditors with a power base, this can be utilized to leverage against smaller creditors, to make the out-of-court workout plausible. Keep in mind that a company has higher likelihood of success in an out-of-court workout if it has something to offer to its creditors.

Lastly, consider the time, expense and low success rate that is associated with companies that enter bankruptcy. It is not always easy to confirm a plan of reorganization, and emerge from bankruptcy with a successful company. In addition, a company must be aware of the fact that a restructuring plan may give rise to claims against the guarantors or co-obligors of the company which will not be resolved or addressed necessarily by the bankruptcy of the entity.

III. Practical Advice in Making a Determination

The goal of either process, must be to fix the real problem; not to fix a symptom or a small issue. Otherwise the process may need to be repeated perhaps in the other forum. Additionally, timing may be everything, so that if the company is already in default of its current loans and obligations, or it anticipates that it will default on its loans and obligations in the short term future, there may not be time to do an out-of-court workout. Of course, it is important to not only explore the availability of emergency financing but also to prepare for bankruptcy even if the company is unsure it will file a petition or if it will choose to pursue an out-of-court workout. This is especially a good idea if the debtor's cash flow is low because it can be costly to put together the documents required to file a bankruptcy petition. Some resources perhaps should be expended to at least make some basic progress exploring financing especially if defaults are imminent or have occurred. This may take some of the pressure off and allow the company an option just in case things implode and an emergency filing is necessary. `

Any decisions during this time should always be guided by "what if" we need to file, or "what if" someone else throws the company into bankruptcy. Otherwise some of what has been put in place can be undone, voluntarily or involuntarily. Lastly, when finalizing a decision, ensure that the solution, whether it is to file for Chapter 11 or pursue an out-of-court workout, addresses both the debtor's short term and long term financial problems and will create a both short and long term solutions. Thinking only in the short term or only in the long term can lead the company to make the wrong decision about which avenue to pursue.

IV. Breach of Fiduciary Duties

Boards of Directors for companies normally owe a fiduciary duty to the corporation and its shareholders. The Board's fiduciary duties include a duty of loyalty and a duty of care.

The duty of loyalty entails acting in good faith and in a manner that is consistent with the best interests of the corporation as a whole. Therefore, a director or officer cannot further their own personal interests. For example, a director or officer cannot usurp the corporation's opportunities. In addition, a director or officer cannot allow their judgment to be compromised by their own personal interests in a transaction. Therefore, if there is a conflict of interest, the transaction can only continue if the director discloses the conflict and the decision is then approved by disinterested directors or shareholders.

The duty of care requires, among other tasks, setting policy, ensuring the policy is carried out, overseeing management, monitoring finances, approving and monitoring a budget, and ensuring compliance with laws, rules, and regulations. In addition, a director or officer must manage operations prudently and reasonably by exercising their authority in an informed basis.

This means that a director or officer should not make a decision before reviewing and informing themselves of all of the material information that is reasonably available to them. Delaware applies a gross negligence standard in determining whether the duty of care has been breached. Gross negligence requires reckless indifference to or deliberate disregard. Therefore, in Delaware, the focus of whether a director or officer has breached its fiduciary duty of care is on the process used to make the decision rather than on the substance of the decision.

The business judgment rule affords some protections to directors and officers from liability for decisions they have made, which in hindsight may later prove to be unwise, but which were made in good faith at the time. The rule creates a presumption that a company's directors or officers have acted in good faith. Therefore, so long as the director or officer acted diligently in making the decision, it is likely the business judgment rule will protect them from any subsequent liability. In order to ensure that a director of officer has been reasonably diligent, courts will consider various factors such as (i) lack of conflicts of interest, (ii) independence, (iii) adequate investigation prior to making the decision, and (iv) whether there was any reliance upon the advice of experts in making the decision.

Zone of Insolvency

When a corporation becomes insolvent, the fiduciary duties the Board of Directors owes change slightly. Instead of owing these duties to simply the corporation and the shareholders, the Board of Directors now owes the same fiduciary duties to the corporation's creditors. In addition to its fiduciary duties, the Board of Directors must also preserve and maximize asset value for the benefit of all stakeholders. Although the Board now owes a fiduciary duty to creditors, creditors may not bring direct claims against directors or officers; rather, creditors can only bring derivative claims on behalf of the corporation.

Because the directors or officers owe fiduciary duties to the corporation, the shareholders, *and* the creditors, situations can arise where it may be difficult to determine what course to follow. For example, when a company is insolvent, the "right decision" for the corporation may diverge from the "right" decision for the stakeholders or the corporation's creditors.

Directors or officers may believe that the business judgment rule discussed above will protect them under these circumstances; however, a director or officer should consider, among other things: whether directors appear on both sides of a transaction, directors expect to derive personal financial benefits from a transaction, evidence exists showing that directors acted in the interests of shareholders rather than the corporation, or directors did not consider material information reasonably available to them. If any of the above are present, then the business judgment rule may not apply and the director or officer can be subject to liability.

Practical Advice for Directors

Directors and officers should be aware of the following practical considerations to avoid being liable for breaching their fiduciary duties:

- Directors should avoid conflicts of interest including being on both sides of a transaction. As indicated above, when this scenario presents itself, the business judgment rule may not apply. In addition, these actions can result in clear breaches of the director's fiduciary duties.
- Directors should avoid preferential treatment to anyone who may be considered an insider.
- Directors should follow corporate formalities and internal written procedures. This includes holding and conducting board meetings, engaging professionals when needed, and documenting the minutes of board meetings, deliberations, and when decisions are made.
- Directors should avoid vacancies on board committees for long periods of time.
- Directors should keep creditors informed including giving notice of the sale of company assets.
- Directors should ensure that company officers are well-qualified and actively managing the organization.