

# Dos and Don'ts for Directors of Troubled (and Not Yet Troubled) Companies

## A PriceWaterhouseCoopers Roundtable

When a public company runs into financial difficulties, it's not just management on the hot seat: the company's directors also come under fire—facing tough scrutiny from the company's creditors, stockholders, and employees, just to name a few. And no matter how well the directors have performed in the past, once their company enters bankruptcy, there is the possibility of extensive litigation and lawsuits where every decision of the directors will be scrutinized and second-guessed.

How can directors recognize when their company is headed towards trouble? What can they do to try to turn things around before it is too late? What new duties must directors satisfy once their company becomes insolvent?

PricewaterhouseCoopers Corporate Advisory and Restructuring LLC (PwC CAR) brought together experts in corporate restructuring to discuss these issues in an October 2006 roundtable. The moderator was *Peter Spratt*, president of PwC CAR and the global leader of crisis management.

The panelists included financial and legal experts and a seasoned corporate director:

*Martin Bienenstock* is an attorney and partner at Weil Gotshal & Manges who co-heads the business finance and restructuring department.

*E. Thayer Bigelow Jr.* currently serves on the boards of Adelphia Communications, Crane Company, Huttig Building Products, and the Lord Abbet Family Mutual Fund.

*Cyrus Pardiwala* is a partner of PricewaterhouseCoopers LLP and also a senior managing director of PwC CAR. He has handled many

restructurings in the U.S. and around the world.

*Geoffrey Raicht* is an attorney and partner in the corporate reorganization group of Sidley Austin, LLP, who has been involved in numerous domestic and international restructurings.

*Tom Sperry* is senior managing director and U.S. market leader of PwC CAR. Prior to PwC CAR Tom headed the restructuring group at Goldsmith Agio and UBS.

## Looking For Trouble

*Spratt:* How can a director spot the red flags indicating that a company may be running into financial trouble?

*Bigelow:* There are typically anywhere from five to ten key indicators. Some of these are financial; others really deal with the health of the business. And with each of those indicators, you can usually drill down into the company's divisions or subsidiaries and see where the problems are.

If you sense that something may be going wrong, you want to look at the company's cash situation. You want a fairly long forecast of what the cash flow looks like and whether the company can service its debt.

*Sperry:* It's helpful for board members to regularly monitor the company's stock prices, its debt-trading levels, its credit rating, and the spread of the company's debt instruments relative to other, similarly rated instruments. This offers a good indication of what the capital markets think about the company's prospects.

If there are any signs of trouble, the board should launch an investigation.

*Pardiwala:* It is important for directors to not just focus on the financial performance of their company itself, but put that performance in the context of their competitors, their industry, and their positioning within the marketplace. If such information is not available from management, that's usually a signal that there are problems. Loss of market share, change of senior management within a short period of time—these are also signals of trouble. When they occur together with signs of financial difficulties,

*Ed. Note: This is the second of three roundtables published in this month's DM. Others are 'Private Equity: The Quiet (But Effective) Corporate Governance Revolution' on page 8 and 'Private Enterprise, Public Trust: The Executive Compensation Challenge' on page 16.*

**Director Summary:** Once a company enters bankruptcy, there is the possibility of extensive litigation and lawsuits where every decision of the directors will be scrutinized and second-guessed. A PriceWaterhouseCoopers roundtable discusses how directors can recognize trouble and what they should and shouldn't do when problems arise.



there is a much greater likelihood the company is facing a crisis—perhaps one that management knows is imminent.

*Bienenstock:* On an increasing basis, boards of healthy companies are asking their management to identify material risks to the company—internal risks such as patents and key employees, and external risks such as the ability to roll over money in a high-yield market or get sources of raw material from distant suppliers. Management then attempts to eliminate some risks, mitigate others, and create contingency plans for the remainder. By reviewing these risk factors and management’s plans for handling these risks, directors will frequently get an early warning of any problems.

Another way of looking at this is to categorize the risks by determining which ones threaten the company’s lifelines for remaining a going concern. Typically, a company’s lifelines will include its lenders, capital markets, customers, and employees. If a company has major problems with one of these lifelines, that can stop a company from being a going concern.

Directors should therefore determine the company’s vital relationships and the potential threats to those relationships. If one of those key relationships starts to fail, that’s a signal for the board to go into action.

Some companies have relied on satisfying Section 404 of Sarbanes-Oxley as their risk control function. Those companies have, in my experience, been uniformly disappointed. If you just comply with Sarbanes-Oxley, you have a super reporting facility, but you haven’t really reduced risk. For instance, if your company has a fire at its most critical facility, you could make sure to tell the financial press before you tell the fire department, but you will not have reduced the risk of the fire occurring.

The boards that go the next step—taking massive amounts of company data and using it for risk analysis—those boards improve their companies and usually the company’s share value.

*Pardiwala:* As boards gain more experience with Sarbanes-Oxley and 404, the boards will see that gathering the required information is not simply an end in itself, but is a valuable tool for helping the company to better understand where risk exists so that management can then deal with mitigating that risk on a more timely basis.

*Sperry:* The sooner a problem is discovered, the more options a company has for dealing with it. Once the problem begins to hit, options narrow. Credit conditions tighten; suppliers start to pull back, etc. It may become more difficult for the company to execute monetizing transactions that could raise liquidity, or to otherwise prevent bad situations from occurring. This can lead to a vicious cycle of one problem creating another which creates another, and so on.

**Many times, there’s not a quick enough shift in mentality from business-as-usual to a recognition that the world has turned upside down and the company needs to respond differently to any number of things.**

### **The Importance of Outside Advisors**

*Spratt:* When should board members turn to outside advisors? What can such advisors bring to the table?

*Pardiwala:* Companies’ plans often are based on their managements’ optimistic expectations for growth. So it can be quite useful for boards to also understand the implications of downside scenarios and what actions could be taken to deal with such an eventuality should it occur. My experience has been that outside advisors often bring that objective view based on a comprehensive risk assessment.

*Bienenstock:* An outside financial advisor will do a sensitivity analysis and say, “What if things are five percent worse than you anticipated? Does the cash still enable the company to pay its debts timely? What if things are another five percent off?” This can alert the board to potential dangers down the road.

*Bigelow:* Not getting a thorough and objective enough analysis is a common error made by boards. Moreover, directors often fail to ask the really tough questions, to find out where the company is headed and what the alternatives are.

*Bienenstock:* The real-time reporting requirements of Sarbanes-Oxley often motivate boards to use financial and legal advisors sooner rather than later. That’s because once the company has run into serious problems, the real-time reporting requirement can require the company to report that it has retained crisis managers or bankruptcy lawyers. Publicly reporting this can push the company into a debt spiral.

However, if the directors retain these advisors before the company has a crisis, then hiring the advisors is not a reportable event, because nothing material has happened at the company. The directors are just doing good governance.

*Sperry:* Outside advisors can also be quite helpful after a company has entered the restructuring process, because most managers are completely unfamiliar with what may happen—not just in the bankruptcy, but in consensual restructuring approved by the courts. The work load is



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different, and different constituencies have to be answered to. The lenders are suddenly at the table, and perhaps some key customers and suppliers. That can be a very unfamiliar place for management and the board. It can feel a bit like Alice in Wonderland.

So one of the roles of legal and financial advisors is to help management and the board understand the restructuring process and foresee what's coming.

### Don't Underestimate The Problem

*Spratt:* When a company starts to run into trouble, what are some of the most common mistakes made by directors?

*Sperry:* After management and the board realize that their company is facing some significant problems, they often underestimate the amount of time and effort that will be needed to address these problems. Many times, there's not a quick enough shift in mentality from business-as-usual to a recognition that the world has turned upside down and the company needs to respond differently to any number of things.

*Pardiwala:* They wait too long before trying to address the problems more proactively. There is a natural proclivity to believe that the problems can be addressed in a business-as-usual manner. The earlier the acknowledgment of the problems, and actions taken to address them on an exceptional basis, the higher the probability for a positive desired outcome.

*Bienenstock:* There is a psychology of all management and many boards to minimize problems. Not because of any wrongful intent, but simply because if a company is in the position of having to go to its lenders to ask for waivers or additional credit, they normally want to be able to say, "This is a small problem, and if you just give me a little bit of relief the problem will be solved."

The danger is that if you get a little bit of relief and it turns out not to be enough, you've lost credibility with your lenders. And if you think it was painful to go to the lenders the first time to ask for relief, it's really painful the second time.

Suppose you initially told the lenders that your company needs a five percent variance on some financial test, but you overestimated the company's revenues and now you need an extra five percent variance. Your lenders will see you as untrustworthy. They will think you don't know how to do projections or manage your business.

On the other hand, if you overestimate the problem when you go to your lenders—if, for instance, you project that your company's revenues will be only \$20 million and they turn out to be \$30 million, the lenders don't say, "Gosh, you were off by 50 percent." They say, "You're trustworthy, you're brilliant, and you're operating the business in the best possible way."

*Sperry:* The natural desire of management to downplay issues can develop into a defensive, bunker mentality. That can effectively strangle the flow of information to outside consultants. This makes the consultants' work more difficult and their advice far less helpful to the company.

*Raicht:* Sometimes, because management and the board believe that they can turn a troubled company around, they wait too long to put the company into Chapter 11. This is dangerous because once the company hits a tipping point, and until it files for bankruptcy, the company is in crisis. During this time, management and the board are under incredible stress to make decisions in a crisis mode. It's a very fertile period for making mistakes.

That's why, during this time, it's important for the company to have the right advisors holding the company's hand. You want people who can say, "We've done this before, and we can get you through this. It is a crisis, but that's what we do, we're crisis managers."

*Bienenstock:* Once the board starts addressing the company's problems, directors often go overboard and say too much to outsiders. Some directors want to talk to creditors, but it's very hard for two or more board members to say the same thing. It's also very hard for board members to talk without unintentionally giving away important inside information. Thus, it is best for board members to refrain from talking about the company to outsiders.

*Raicht:* The directors should also avoid talking to employees about plans for the company, because this may wind up giving employees some expectations that the company is unable to satisfy. Anything the directors want to say about restructuring the company should be kept in the boardroom, and the directors' decisions should be disseminated to employees through a very careful process.

### Conflicting Duties

*Spratt:* Once a company enters Chapter 11, how do the fiduciary duties of the directors change?

*Raicht:* When a company is solvent—which is not always easy to determine—the board's main fiduciary obligation is to the company's shareholders. But as the company approaches insolvency, the board also takes on a fiduciary duty to the company's creditors. This forces board members into a very, very delicate dance, trying to balance their duties to both shareholders and creditors. There are a host of cases coming out of Delaware, for instance,



where the courts have rejected companies' efforts to protect shareholders to the detriment of creditors.

Unfortunately, there is no bright line to determine when a company is approaching insolvency and so must start acting in the best interests of its creditors. The decision is always fact-specific and issue-specific. That's another reason why advisors are so important, because directors need advisors to help them discover when the company is approaching the zone of insolvency.

*Bienenstock:* Because of the conflicting pressures put on boards of financially troubled companies, directors should assume that they will be sued for the decisions they make. They need to realize that all their actions may be eventually scrutinized in court, and they must continually ask themselves, "What will we want to present as our defense if a lawsuit comes?" The answer is that they will want to make maximum use of the business judgment rule—which states that so long as the directors go through the proper decision-making process, they are not liable if their decisions are eventually shown to be wrong.

Thus, the directors will want to show that they instructed management to identify the risks; they hired the right outside advisors to analyze their alternatives; and they spent adequate time discussing the alternatives and their impacts on different constituencies, including shareholders, creditors, customers, and surrounding communities. The last thing directors want is to have a Walt Disney situation, where the record shows that in a matter of minutes, the board approved a major decision that had a major financial impact.

If the directors go through a thorough decision-making process, they're going to be proud of the record that will be uncovered.

A thorough decision-making process also will frequently lead to decisions that improve the going concern value of the enterprise. Even if it's finding the least worst result, that's the directors' job, to find the least worst result.

*Sperry:* Quite often, in my experience as a financial advisor, the management of a troubled company will push for the company to follow a path that is simply not feasible. It can be difficult for an advisor to prove the path isn't feasible, however, since it comes down to a matter of forecasting and judgment.

Nevertheless, if the board uses a thorough decision-making process, they can produce good results. Their financial advisors can examine all the alternatives and, in conjunction with their legal advisors, point out all the obstacles to achieving success along management's proposed path. That's going to have a salutary effect on management, and it will enable the company to solve its problems faster and with less disruption.

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### The New Bankruptcy Law

*Spratt:* Do you think the bankruptcy code changes in 2005 have helped troubled companies or their directors?

*Bienenstock:* The changes in the bankruptcy code have added to the difficulties of companies going through Chapter 11. Congress imposed new restraints on retention plans, executive pay, and severance plans—key financial incentives aimed at getting top personnel to sign on or to stay with the company.

This has hamstrung managements and boards, making it much harder for them to get and keep key people that the company needs. These key people now face the risk that any financial deal they make with the company will be partly or totally set aside by the bankruptcy court.

The bankruptcy code still allows retention plans, but the top retention amount cannot exceed ten times the average retention amount given to non-management employees. This frequently makes the top retention amount insignificant and inadequate. Moreover, the statute doesn't allow any deviation from the caps on retention plans.

There may be a way around the cap, however. A company may be able to offer key employees an incentive plan as opposed to a retention plan. A retention plan basically means the employee is paid extra to remain with the company until a certain date. An incentive plan could mean the employee is paid extra if the company is successfully sold.

Some people argue that this type of an incentive plan is just a camouflaged retention plan, because the employee is still getting extra money to stay put. This is a gray area of the law. And this legal uncertainty makes it harder to deal with the situation.

*Raicht:* Another problem is that these "retention-type plans" seem to get teed-up right around the time a creditors' committee is being formed. Nothing upsets a creditors' committee more than seeing a company's management team receiving a lot of extra money, when creditors are expecting only cents on the dollar. This often creates significant tension between the company and its creditors' committee, and this tension needs to be handled carefully, so that it doesn't destroy that relationship. Because the committee is a player, the company will need to work with the creditors' committee throughout the Chapter 11 case.