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VIEWPOINT

SPECIAL ISSUE

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- **VIEWPOINT 33: M&A Strategies In A Down Market**

WHY THIS MATTERS:

Many CEOs and board members are unfamiliar with the heightened personal exposure to liability that comes into play when a company is financially distressed.

Executives tend to focus on strategies that maximize the opportunity to create value for shareholders. If the financially distressed Company has significant outstanding debt, then such long-term strategies, which often require investment of capital, may later be seen by a court to have "deepened" the Company's insolvency.

Companies that in the past have been able to access new capital – in the form of new equity investment or debt financing – will find that such capital is much harder to come by in 2009, and without that new capital, many businesses will find themselves in financial distress.

TIPS FOR TROUBLED COMPANIES

TEN THINGS EVERY OFFICER AND DIRECTOR SHOULD KNOW

By Jamie Grant, Mirus Special Situations Group

In our 22 years of experience advising middle market companies, we have found that in times of financial distress and market dislocation, business leaders are often too slow to recognize a trend, and therefore too slow to make the critical changes that are necessary to avoid losses. Such hesitation is natural, especially for entrepreneurs. But there is also a false sense of security that many executives and board members share, that stems from a common misconception of fiduciary duty. Fiduciaries generally understand their duty as "generating value for shareholders", which is only part of the equation. In this month's Viewpoint, we will provide executives and directors with valuable insights into how their fiduciary responsibilities expand when a Company becomes financially distressed, and offer a number of helpful tips that might guide decision-making and help the officers of a business to reduce their personal liability.

Recessions are notoriously hard to spot, which is one reason that many business owners will attribute a fall-off in revenues to something that can be controlled – perhaps blame the sales organization or believe a customer that says their "buy decision" has simply been delayed. Even an experienced operator might adopt the view that "this is just a blip," because recognizing a downturn would mean implementing a painful layoff. In the meantime, the Company fails to cut costs in the face of declining revenues.

Most CEOs and board members of troubled companies fail to

acknowledge that the Company is truly distressed until there is a third party "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 twelve-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.

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THE LIST:

While every situation is different, we have endeavored to come up with a list that if not comprehensive, is at least instructive, in order to persuade the decision makers of a business that once the Company is distressed, they need to begin operating by a different set of assumptions in order to reduce their personal exposure to liability. Thus, our list of the *Top 10 Things that Every "Troubled Company" CEO and Board Member Should Know:*

1. **Understand "The Zone of Insolvency".** In approximately 50% 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 whether the scope of that duty merely expands to include creditors, or whether 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 then 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 later 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.

2. **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 director of the Company, 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 their 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.

3. **Consult specialized insolvency professionals.** You wouldn't ask your family doctor to perform brain surgery, so don't depend on a generalist for advice on insolvency matters. Work with an attorney that specializes in corporate insolvency and bankruptcy, and consult a turnaround specialist who has experience negotiating with creditors, landlords, and unions if applicable. 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 their firm if necessary to represent the Company's interests.

4. **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.

5. **Understand your WARN Act liability.** The Worker Adjustment and Retraining Notification Act (WARN Act) is a United States law protecting 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.

6. **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 just for one last shipment) can result in personal liability, and in some cases criminal charges against the officers (or employees) involved.

7. **Don't fall into the asset-based lending trap.** The asset-based lending model, which many companies now rely upon for working capital, can create perverse incentives that troubled companies should be careful to avoid. As an example, we once worked with a manufacturer of custom flooring that would always manufacture 110% of the order, in the event of any defects. Once the order was shipped, the remaining overage would be liquidated at a factory outlet store. The Company would maintain the inventory as finished goods, at a pre-determined discount, until sold. However, when cash became tight, the Company closed the outlet. From that moment, the right thing to do would have been to write down the excess inventory, or increase the reserve. However, such measures would have reduced the Company's available working capital, so management opted not to reclassify the inventory. This measure bought the Company some time, but ultimately was counter-productive as it caused management to lose credibility with the bank.

8. **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 accrued 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.

Consult specialized insolvency professionals. You wouldn't ask your family doctor to perform brain surgery, so don't depend on a generalist for advice on insolvency matters. Work with an attorney that specializes in corporate insolvency and bankruptcy, and consult a turnaround specialist who has experience negotiating with creditors, landlords, and unions if applicable.

9. **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's also painful, expensive, and best to be avoided. After such major bankruptcy restructurings as American Airlines, Delphi Corporation, 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 re-negotiate 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.

10. **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 prior to filing, etc. Further, the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") of 2005 severely limits the administrative priority claims for certain types of executive compensation and severance in the event of bankruptcy. Specifically, the Act 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. Therefore, 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. Retaining such professionals is one way to reduce risk for the fiduciaries of a Company. Finally, Chapter 11 isn't the worst thing that can happen. The fact of the matter is, 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.

If you would like to talk with our experienced team about strategic alternatives and financing options for your business, or get a referral to a competent insolvency attorney or an experienced turnaround management firm, please contact Jamie Grant of the Mirus Special Situations Group at 781-418-5928 or by e-mail (**grant@specialsituationsgroup.com**), or visit us on the web at **www.specialsituationsgroup.com**.

Jamie Grant *is a partner at Mirus Capital Advisors, Inc. Founded in 1987, Mirus Capital Advisors is a middle-market investment bank that specializes in merger advisory, capital-raising services, fairness opinions and valuations to entrepreneurs, corporations and professional investors. By combining a proven process, industry and transactional expertise, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Our affiliate Mirus Securities, Inc. is a registered broker-dealer and FINRA/SIPC member. Additional information about the firm is available on our website* **www.merger.com.**

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