

Managing Troubled Companies and Crisis Situations

A Guide for Sustainable Entrepreneurs

SUSTAINABLE ENTREPRENEURSHIP PROJECT

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Preface

This Guide focuses on management practices of companies that encounter strategic, financial, managerial, economic and/or operational issues that stall their growth and suddenly place them in a crisis situation where survival becomes the immediate goal and objective. The Guide includes a discussion of potential causes for operational and financial problems and guidance on diagnosing problems and implementing recovery strategies. The Guide also covers crisis management include risk factors for potential crisis situations and design and implementation of crisis management plans and programs. Finally, the Guide explains and analyzes prudent governance practices in troubled times including the steps that need to be taken by directors and senior officers to meet their fiduciary responsibilities to shareholders, creditors and other stakeholders.

Chapter 1

Managing Troubled Companies

§1:1 Introduction

A surprisingly high percentage of companies will ultimately be forced to effect some sort of major restructuring or re-sizing of their business at some point along the way even when they are still in the rapid growth phase and have sufficient product and market opportunities available to them.¹ A crisis can be triggered by any number of different factors, some of which are realistically outside of the company's ability to control or anticipate. Some of the most commonly seen examples of causes of crisis for emerging companies are the following:

- Product competition, which may be caused by problems in the design or functionality of current products and/or the failure to timely develop and launch a new generation of products.
- Price competition, which may be caused by competitors entering the market with imitative products and/or the failure to aggressively reduce the firm's own cost structure.
- Product quality problems, which may be caused by process engineering issues in the manufacturing process and/or poor performance by suppliers and subcontractors.
- Rapid reductions in market demand, which may be caused by a failure to adequately research and evaluate the target market and identify factors that might influence buyer behavior.

In addition to the fairly broad issues listed above, a crisis may erupt from a relationship with a single customer or business partner. For example, a company's growth and development may be slowed or stopped by an expected delay or cancellation of a large contract with a key customer. The same result may follow from an ill-advised acquisition which depletes the financial and managerial resources of the company when it should be focused on new product development or other activities that are essential to the maintenance and growth of its current product line.

Crisis management becomes even more challenging as companies are forced to overcome multiple problems at that same time, as is generally the case. In some cases, the problems are relatively independent and unrelated, such as dealing with an acquisition at the same time that the company is struggling to develop the next generation of its existing product. In many situations, however, the issues are related and begin in one area and then extend up and down the value chain. For example, product or price competition may cause the company to rush its product development efforts leading to problems with product design and/or process engineering. As a result, launch of the new product is delayed and initial units come with a high level of quality and performance issues. Quickly, the company is confronted with the danger of erosion in customer confidence,

¹ W.P. Summers, "Rapid Growth and Fast Retreats," Booz Allen & Hamilton Outlook, 11(1987), 48-52.

declining sales and a shortage of cash to fix the problem. Add to the mix the inevitable downturn in employee morale, and potential loss of talent needed to address the aforementioned problems, and you have all the elements of a massive crisis that could well bring the firm to its knees.²

§1:2 Potential causes for operational and financial problems

Operational and financial difficulties are not confined to new and untested businesses, and it is essential that companies remain diligent and sensitive to some of the early warning signs of problems so that preventive and remedial actions can be formulated and taken before things get out of hand. Specifically, managers must be mindful of the possibility of a variety of commonly occurring problems and be prepared to accept intervention and turnaround assistance. The potential sources of operational and financial difficulties are numerous and each situation is different. For purposes of illustration, however, problems can be categorized as follows:

- Strategic problems, including failure to develop or execute a realistic business plan;
- Operational problems, including problems with staffing, engineering, production, sales and marketing;
- Financial and accounting problems, including problems with collections, budgeting and use of internal management reports;
- Management difficulties, including lack of experience and inability to retain personnel; and
- External factors, including a general downturn in economic conditions and regulatory changes.

In addition, smaller firms caught up in pursuing aggressive growth objectives often are confronted by an array of “growth pressures” that will invariably strain the already scarce resources of the firm including the following:

- Expanding the infrastructure of the firm, both physical and human, beyond current needs in anticipation in growth and greater activity in the future. This includes buying or leasing larger facilities or staffing up in manufacturing and marketing before a new product has been fully developed and launched.
- Undertaking expensive capital investment in manufacturing equipment to build additional capacity before demand increases to a corresponding level.
- Building up inventory levels beyond current demand, which reduces capital available for other activities. In addition, the interest and carrying charges associated with excess inventory must be covered out of current cash flow.
- Focusing on attainment of revenue targets while neglecting gross margins.

A comprehensive study of the growth experiences of about 500 larger companies over the last several decades indicated that almost 90% of the firms had encountered one or more “stall points”—defined by the researchers as “the start of secular reversals in company

² S. St P. Slatter, “The Impact of Crisis on Managerial Behaviour,” *Business Horizons*, May-June (1984).

growth fortunes, as opposed to quarterly stumbles or temporary corrections”—that often led to the removal of the then-current management team and created a real risk that failure to take appropriate timely diagnostic action would result in permanent impairment of the firm’s ability to return to healthy top-line growth.³ When searching for the “toot causes of the stalls in revenue growth among the survey firms that researchers noted that while 13% of the problems were from sources outside of the control of senior management (i.e., regulatory actions, economic downturn, geopolitical changes and national labor market inflexibility) the remaining 87% of the problems were strategic and organizational factors that were arguably within management’s control including the following four main reasons presented in order of frequency:

- “Premium-position capacity” was the name the researchers gave to the category with the largest number of factors contributing to serious revenue stalls and this phenomenon was defined as “the inability of the firm to respond effectively to new, low-cost competitive challenges or to a significant shift in customer valuation of product features.” Specific factors included in this category were disruptive competitive price or value shift, overestimation of brand protection, gross margin captivity, innovation captivity and missed strategic inflection in demand.
- The second most frequently identified reason for stalling was “innovation management breakdown,” which was defined as “some chronic problem in managing the internal business processes for updating existing products and services and creating new ones.” Symptoms of problems in this area included curtailed or inconsistent funding for research and development (“R&D”) activities, excessive decentralization of R&D activities, slow product development, inability to set new standards, conflicts with core company technologies and over-innovation.
- The next more frequently identified issue with respect to stalling was “premature core abandonment,” which was explained as “the failure to fully exploit growth opportunities in the existing core business” and characterized by “acquisitions or growth initiatives in areas relatively distant from existing customers, products, and channels”. Specific factors in this category included financial diversification, misperceived market saturation and operational impediments and pursuit of international growth that masked core problems.
- Fourth on the list of main reasons was “talent bench shortfall,” which referred to “a lack of leaders and staff with the skills and capabilities required for strategy execution”. Specific factors in this category included internal skill gap, narrow experience base, loss of key talent and key person dependence.

Other categories of strategic factors that had a material impact on revenue growth in many instances included failed acquisitions, key customer dependency, strategic diffusion or conglomeration, adjacency failures (i.e., overextension of the “formula” and/or inability to manage new business models) and voluntary growth slowdown. Other categories of organizational factors that led to problems included board inaction, faulty organizational design and use of incorrect performance metrics.

³ The discussion of the results of this study, including the reasons and related factors described below, is adapted from M. Olson, D. van Bever and S. Verry, “When Growth Stalls”, Harvard Business Review (March 2008), 51-61.

§1:3 --Strategic problems

Unfortunately, many companies lay the foundation for future financial difficulties when they make certain strategic decisions regarding the direction and operations of the firm. Examples of this type of problem include the following:

- Companies often run into problems when they focus on growth while forgetting the need to attain profitability. Companies may continue to take on low-margin business to increase market share instead of concentrating on customer relationships with higher margins.
- Companies often waste resources in attempting to expand into unrelated business areas and markets. Not only does the company lack the managerial and technical resources to successfully diversify, it loses focus on its primary activities and wastes cash.
- Companies are much more likely to run into cash flow problems when their ability to introduce new products is dependent on successful completion of an extensive product development. Not only do these projects burn substantial amounts of cash before corresponding revenues can be realized, they are also vulnerable to delays, unforeseen cost overruns, and the heightened possibility of pre-emptive competition.
- Companies are often surprised by their troubles and find themselves without a contingency plan for dealing with slow sales or collections.
- The loss of a major customer, supplier, or lender is clearly a sign of actual or potential problems for the company. Dissatisfaction within the company's customer base may mean a number of things, including the inferiority of the company's products, poor service, or the lack of an ability to effectively compete with the pricing policies of the company's competitors.

Diversification is one of the trickiest strategic issues that any company might face as it grows and evolves. Diversification is generally a risky proposition; however, failure to do so may cause the firm to become overly dependent on a single product. Some firms that successfully launch a product become so involved in selling and supporting the item that they neglect to invest resources in other business activities, particularly new product development. Management must assess the impact that a diversification strategy might have on its ability to remain competitive in its existing target markets. For example, if a firm that supplies specialized components for use in systems manufactured by larger companies in a particular industry decides to enter the systems business on its own, it may experience significant erosion in its components sales. Moreover, a crisis is likely given that management may have little or no experience in manufacturing and selling entire systems, as opposed to the components that formed the foundation of the company's earlier growth.

Technology management is another area of concern for fast-growing firms that have staked their strategy to achieving and maintaining an advantage based on what was anticipated to be a strong intellectual property position. Unfortunately, patents are often not an effective method for protecting the proprietary technologies developed by small

growth firms. In many cases, the cost of preparing, filing and prosecuting a patent application in one or more geographic markets may be prohibitive for the small company and the short product life cycles that are often in effect may mean that the product is off the market by the time that the patent is issued. In addition, the definition of patent claims in emerging technical markets is an inexact science and larger competitors have the resources and know-how to invent around, or break, a smaller firm's patents. In addition, perceived innovation that might lead to a dominant patent portfolio invites challenges from actual or potential competitors and a firm's technology management efforts may be overwhelmed by the need to defend costly and time-consuming patent infringement litigation.

As a general matter, many of the strategic problems that eventually lead to a crisis are based on an inability of the management team to effectively plan for contingencies. Companies involved in dynamic and emerging markets are uniquely vulnerable to changing market demands and conditions. Some of the factors, such as unforeseen external events that impact the buying patterns of customers, cannot be predicted and often damage or destroy the most promising businesses without fault by the managers. Other issues can, however, be better managed, such as reliance on projections of market growth that are unrealistic and based on assumptions that have not been critically tested. In many cases the founders of an enterprise revel in the pursuit of new technologies, products and/or markets and celebrate the fact that the firm is taking an unorthodox path to success; however, effort and resources must ultimately be invested in planning processes and critical assessment of the key assumption upon which the direction of the business of the company are based.

§1:4 --Operational problems

Strategic issues are almost always identified when companies are in trouble; however, in many cases firms start to drift off course slowly but steadily by neglecting basic operational issues that can arise anywhere along the value creation chain. Some of the symptoms of operational failure include the following:

- Companies may have difficulties recruiting qualified and experienced personnel who are familiar with the demands of rapid growth and the inability to staff key functions may create bottlenecks that impair the company's ability to complete product development on time and manufacture and distribute products at the pace demanded by market opportunities.
- Companies may be confronted by engineering problems in their manufacturing processes and difficulties in scaling up production to meet rapidly increasing customer demand while maintaining acceptable quality levels and delivery standards.
- Even when companies are able to manufacture the products effectively growth may be disrupted by distribution issues that impair their ability to deliver the products in the manner required by prospective customers.
- Companies are unable to design and implement effective sales and marketing strategies that communicate the benefits of their products to prospective customers.

A related issue in the sales area is an inability to consummate sales that provide an acceptable margin with reasonable assurance of timely payment.

While capital and technology are two of the most often mentioned causes of crisis for rapidly growing small firms it is important not to forget the significance of human resources strategies. In general, growing companies have little difficulty in recruiting talented candidates for management and technical positions. In turn, when growth slows, the quality of the interested talent pool also tends to deteriorate. Small growth firms often make significant errors when projecting and filling staffing requirements based on anticipated growth in market demand for their products. It is a difficult balance, since the company needs to be in a position to capture the benefits of rapid increases in demand for its products; however, any misstep in forecasting volume or the timing of sales means that the firm must absorb significant overhead costs for employees that may not be fully utilized. A similar dilemma arises when staff in one functional area has little to do because of delays in projects housed in another department. For example, marketing activities for a new product may need to be put on hold if there are significant delays in new product development or engineering.

Process engineering failures are another common cause of problems for small growth firms.⁴ Managers need to identify the key engineering issues that need to be resolved and make sure that relevant performance measures are closely monitored. For example, great care and attention should be paid to yield as an appropriate and accurate measure of manufacturing efficiency and engineering quality. Due to their own lack of resources, small growth firms often rely on outside contractors to perform various activities relating to the manufacturing process. In addition to the usual delivery and quality issues that arise in any such relationship, consideration must be given to the stability and management of the contractor, particularly since many contractors are themselves small and relatively fragile.

The type and causes of manufacturing problems vary with the size of the business. For example, when the firm is small, it generally lacks the resources to undertake a high volume of in-house manufacturing activity. As a result, the company is forced to rely on a network of key suppliers for the manufacture and assembly of its products. If the network is not effectively managed, or the chosen suppliers prove to be unreliable, the company will be confronted with an array of product and process engineering issues that will ultimately lead to customer dissatisfaction and poor sales performance. On the other hand, as the company grows and acquires the resources necessary to take on most, if not all, the necessary manufacturing activities, it must nonetheless work to ensure that it identifies and maintains an appropriate mix of in-house activity and outsourcing. For example, while the firm wants to retain control over all stages of the value chain, from manufacturing of basic components to final assembly, it may be more cost and time efficient to outsource certain activities to third parties. Outsourcing is also a good strategy for dealing with occasional spikes in demand, as opposed to building excess internal capacity that is largely unused for extended periods.

⁴ Id. at 253.

An inability to make timely delivery of products, for whatever reason, can create serious credibility problems for a new company with little recognized track record among customers. In some cases, demand simply exceeds any expectation that the firm may have had when it made its initial projections. In that case, poor delivery performance occurs because manufacturing simply has too large a backlog. The more typical problem, however, is manufacturing inefficiencies, technical and engineering issues or a lack of discipline in the sales area when promising deliveries to new customers.

Finally, even when companies have been extraordinarily successful and innovative with respect to product development and the design of manufacturing processes they will not be successful unless they create an effective sales and marketing strategy. Some of the more common marketing problems that may be experienced by companies in crisis include the following:

- The sales effort was poorly targeted, typically because the company had failed to clearly define its product and market focus. A related issue is weak management in the sales area.
- The product was improperly priced at various stages of the product life cycle. For example, companies were often reluctant to charge an appropriate premium for the product when it is first introduced and demand is high and competition is low. Then, at the other end, the firm is slow to recognize the need to lower the price as the market matures.
- Sales personnel lack the technical and industry experience to understand the product and explain it effectively to customers. This occurs as the firm grows quickly and responsibility for sales shifts from the founders and design engineers to a professional sales group with generic, as opposed to specific, experience.
- The company fails to research and understand the buying behavior of potential customers, which ultimately leads to adoption of inappropriate and ineffective marketing strategies.

§1:5 --Financial and accounting problems

Even when a company is making appropriate strategic decisions, the firm must continue to closely monitor its available cash. Cash is the oxygen of the business, and even a brief depletion can permanently harm the company's health. As described in the following examples, problems in this area include not only shortfalls created by collection problems and cost overruns, but also the failure to establish a clear and timely reporting system:

- One obvious sign of a troubled company is the failure to make timely payments on material obligations, including payments to investors under the terms of any debt securities or payments to the company's bank or other commercial lenders. In many cases, this follows from poor or inadequate planning or budgeting or a prior decision to fund perceived growth opportunities by taking on excess debt.
- Troubled companies often have difficulties producing accurate and timely financial information and systematically fail to prepare and follow cash budgets and projections.

- Another common problem with many companies is the lack of standard costs against which the company can compare its actual manufacturing and sales outlays.
- Backlog is a key performance indicator. Declining backlog is a sign of future problems, since it typically indicates that the company's products are not achieving the required level of marketplace acceptance. Increasing backlog may be a sign of growing sales activities; however, there may be other factors at work that may cause concern, such as difficulties in shipping and meeting production schedules.
- Material changes in balance sheet items, particularly in the areas of inventory and accounts receivable, can also signal problems. Substantial increases in inventory mean that sales are not keeping up with production levels, an indication that the company's products are not doing well in the marketplace. Large accounts receivable figures may signal collection problems.

One symptom of weak management is the lack of adequate financial controls and information systems. In many cases, companies, particularly smaller firms overwhelmed by rapid growth, fail to implement budget processes and controls, including cash flow forecasting and costing systems. Even when systems have been created, firms often do not track and measure the variables that are the most important indicators of the health and progress of the business. For example, a company may gather and present sales information on a geographic basis, as opposed to product-by-product. This type of system makes it more difficult for management to spot declining sales for a particular product, which may mean the product is reaching the end of its life cycle or that upgrades or enhancements are needed in order to maintain the competitiveness of the product. The type and scope of financial controls also needs to be continuously revisited as the firm's business model evolves. For example, if the company decides to take on higher value-added products, it must focus on development and use of inventory controls since expense in that area will likely increase dramatically in light of the change in product mix. Also, as sales grow, more emphasis must be placed on tracking receivables and collection of bad debts.

Financial management in a rapid growth environment demands special skills and experience from the firm's chief financial officer. In many cases, the chief financial officer ("CFO") is slow to identify changes in the business that will require modifications to the financial controls used by the company. Also, hiring a CFO with experience in a large firm environment may not be the answer for smaller companies. While such a person is likely to be familiar with comprehensive formal budgeting and control systems, he or she may not be able to adapt to the dynamic and fluid cultural environment that exists in a small growth firm.

§1:6 --Management difficulties

Not surprisingly, one of the key causes of trouble for rapidly growing businesses is a lack of management skills and experience. Some of the problems that typically arise in this area are the following:

- Many founders, with their technical backgrounds, are ill prepared for the task of

managing and mentoring others yet are unwilling and reluctant to recruit outsiders who might be better able to manage the myriad of challenges associated with firm growth. If senior management cannot delegate tasks to various levels in the organization and establish the communication and reporting structure required to track what is going on, the business will quickly begin drifting.

- Although cash is the lifeblood of the business, many business owners will delay adding experienced finance personnel until the business has grown larger. Unfortunately, once an experience controller or chief financial officer is hired, he or she will often find that records are incomplete and that finance reports are inaccurate.
- All businesses benefit from the institutional knowledge collected by senior managers. If, however, the company is not able to keep its key management personnel, it loses people who take with them unique knowledge about the company's technology, customers and markets.

§1:7 --External factors

In many cases, trouble can come from external sources that are out of management's control. For example technological changes may quickly lead to obsolescence or give competitors new strategic advantages; companies may find themselves in an industry that encounters a general slump; regulatory changes may substantially affect the company's business; and changes in general economic conditions, such as interest rate increases or inflation, may also cause problems.

§1:8 Diagnosis of problems and implementation of recovery strategies

As noted above, every situation is different and management of a troubled company cannot make an intelligent decision regarding appropriate recovery, or "turnaround", strategies until a thorough diagnosis of the company's operational and financial condition has been completed. Companies that get into significant financial difficulties often turn to outside professionals, so-called "turnaround specialists", who investigate the major causes of the company's problems and take the lead in discussions with creditors, investors and management to develop a new strategic plan. The board of directors should also be actively involved at this stage in order to fulfill their fiduciary responsibilities to the shareholders of the company and other interested stakeholders and to contribute their own expertise and experience to management's efforts to steady the situation. Director involvement is also needed to review the performance of the management team and, if necessary, make changes in key positions including the chief executive and financial officers. Directors and senior executives should be guided and supported by advice from the company's outside legal and accounting firms.

The diagnostic stage involves an independent review of each of the potential problem areas to identify the causes for the company's financial difficulties. This process is crucial since management is often unable to objectively scan for deficiencies in the company's business plan or operations. The objective of the diagnostic process is to come up with a list of actions that can be taken to stabilize and rehabilitate the business. The list should be carefully organized on a priority basis. At the same time, decisions

must be carefully considered before implementing. For instance, revisions to the business plan should be deferred until it is determined how much cash is immediately available and whether there are any assets that can be liquidated to improve the cash position without permanently harming the business. Similarly, wholesale changes in the management team should be delayed until a determination has been made about how each manager has actually performed and how his or her performance is related to the company's operational and financial struggles.

The length of the diagnostic stage will depend upon a variety of factors including the extent of the damage that has already occurred and the speed with which information regarding operations and finance can be collected and analyzed. In most cases management will implement several short-term initiatives in the following areas:

- Management of working capital, including processing and billing of orders received by the company and inventory control of parts and finished products. Though essential, this is not always an easy area to deal with, particularly if lengthy payment periods for receivables are required for the company to remain competitive.
- Unfortunately, up to 80 percent of the immediate savings for troubled companies can be found in reducing the workforce. This step should be taken cautiously with input from legal counsel specializing in employment law matters and should be done in a manner that takes into account overall morale of the workforce including employees who will be remaining with the company yet are uncertain and frightened about the direction that management is going.
- If possible, excess capacity and under-utilized assets should be shed for cash and to reduce fixed expenses. If possible, long-term leases should be surrendered to the landlord or subtenants should be found.

Obviously it is not enough to simply stop the bleeding to save a troubled company. In addition, the management team, working in conjunction with the board of directors and any outside turnaround adviser, must develop a turnaround plan that puts the company on the road to long-term health and survival and addresses the concerns of investors, creditors, other key business partners and employees. The plan should include specific recommendations and action plans for improving performance and removing problems within the business, as well as detailed projections that can serve as milestones to measure if the company is moving in the right direction. A plan can be used to provide direction to employees and give them goals to strive for rather than worrying about day-to-day survival. Also, a comprehensive turnaround plan can be used as a bargaining tool in convincing creditors that they are better off working with the company than forcing it into bankruptcy. As a general matter, a turnaround plan typically addresses restructuring of the management team, resolution of financial problems through cash management and controls, cost and asset reduction, improvement of employee morale, rebuilding credibility with customers, suppliers and other business partners and implementing changes in business and marketing strategies. The plan should include objective business and financial milestones that can be referenced to measure the effectiveness of the plan.

§1:9 --Management

While it is certainly possible for companies to attempt to weather a troubled period with the same management team that took the lead during better times it is not surprising that one of the first steps taken by the directors of a company in a financial or operational crisis is to shake up the senior executive group including dismissing the CEO and other C-suite members. While it is commonly believed that most turnarounds are directed by professional managers that specialize in dealing with troubled companies, in fact many companies look within for a new CEO and other members of the senior management team. Regardless of where the CEO is found, that person must have substantial professional managerial experience and must be prepared, due to resource shortages, to take on duties in a number of functional areas. Technical skills are also important, since the CEO must clearly understand the relevant technology in order to make quick and thoughtful strategic decisions; however, management experience is most important. Finally, the ideal CEO candidate for a turnaround situation must have the interpersonal skills to recruit and motivate talented people and instill confidence in the firm's skeptical business partners. Small companies often seek help from executives with substantial experience working with larger firms including management during troubled periods. While there is nothing wrong with this strategy care must be taken to ensure that the executive is personally motivated and able to work in a small company environment with none of the frills and resources offered by a large company.

In addition to appointing a new CEO, companies in crisis typically recruit a new CFO and/or add more support for the accounting and finance area. These steps are deemed necessary to ensure that adequate control systems are designed and implemented immediately and that cash-related problems are identified and resolved. The new leaders of the accounting and finance function must be able to understand and satisfy the requirements that will be imposed by lenders and investors with respect to budgets and reports. In many instances the decision of outside creditors to forego immediate legal action against the company hinges on their comfort with the CFO and his or her ability to eliminate cash management and internal control issues that often lead to the crisis. Marketing is another important function where staffing changes are generally made; however, given the need to rebuild and maintain customer relationships it is likely that the CEO will be personally involved in implementing remedial steps in this area. Finally, the members of the management team during a turnaround period must have the necessary communication skills to calm the concerns of all of the key stakeholders of the company including employees, creditors and investors, other business partners and representatives of regulatory bodies responsible for overseeing the company.

§1:10 --Cash management and controls

One of the most common symptoms of crisis is insufficient cash flow to satisfy the day-to-day obligations of the business and troubled companies must move quickly on several fronts to address and resolve cash problems. In most cases, this means implementing procedures and controls that should have been in place all along, which generally dictates that a change in leadership in the finance area (i.e., the CFO) is necessary. While support staff in this area are often added at this point, in some cases the better answer is to replace

ineffective personnel with experienced and motivated experts in key specialties such as cost accounting, budgeting, financial reporting and credit. Evidence of a strong accounting and finance team with authority to make the change stick throughout the organization is generally a prerequisite to further funding from outside investors and at least a short period of patience from banks and other lenders.

The company must implement comprehensive and reliable systems for monitoring cash flow on a day-to-day basis. Past practices of monthly and quarterly cash flow forecasts and reports should be abandoned since they fail to pick up the significant fluctuations in the cash position that occur daily and which can bring the firm down when it is working with no reserves. Each person with responsibility for resolving payables with creditors and collecting receivables from customers should have full and open access to current cash balance information. In this way, they gain an understanding of the importance of their activities and management can quickly identify creditors and customers that require immediate attention and provide informed guidance to staff on how to deal with those parties. The goal is to build a team that understands how payment or receipt of a particular check impacts the performance and financial health of the business.

The CEO should be actively involved in cash flow and cash management procedures and should insist on daily reports that list all receipts and disbursements. The report should also list all anticipated receipts and disbursements over the next 30 days, since short-term financial planning is crucial at this stage for the small firm in trouble. In many cases, all checks must be signed by the CEO and no check will be approved unless it has appeared on the daily report for a specified period of time and has been reviewed and approved in advance by the CEO. All employees should be instructed to collect all of their projected disbursement requirements over the next three to six months and submit them immediately to the CEO and CFO. In turn, senior management must act quickly to review all requests for funds and advise the requesting parties of the decisions regarding funding. Certain disbursements must, and should, be given priority as failure to pay would result in a default that could bring down the entire company. Examples include payments to commercial lenders, landlords or key suppliers. Other disbursements may be conditioned upon the occurrence of certain events, such as timely payment of large receivables, and parties requesting the disbursement should be kept apprised of progress on satisfaction of any conditions.

Each product and customer relationship should be subjected to intense and exacting cost analysis. This step is often neglected by smaller companies as they typically lack the experience or resources to implement cost accounting systems and collect and allocate all of the costs that should be taken into account to determine if a specific product is profitable. Similarly, while the margin on sales to a particular customer may appear to be acceptable, there may be hidden costs, particularly in the areas of marketing and service, which erode or even eliminate any profits associated with the relationship. It is, therefore, important that the company begin to carefully monitor its fixed overhead and allocate an appropriate portion to each customer relationship.

Cash management and controls should be incorporated into the broader turnaround plan for the company through the inclusion of elements such as the following:

- Offer of substantial discounts on outstanding receivables in order to elicit quick cash payments from customers;
- Sale of excess raw materials to third parties including competitors, coupled with sale of excess inventories, at discounted prices or on favorable credit terms to generate cash;
- Putting payment of accounts payable on hold except for vendors that are truly necessary for the company's survival; and
- Negotiation of loan extensions with lenders, often with concessions such as enhancing collateral and assigning payments directly to the lender.

Lenders and trade creditors often have real incentives to work out a solution outside of insolvency. For example, lenders generally will operate on fairly small margins when making loans and are not interested in writing off an entire loan or incurring additional expense pursuing their claim in insolvency. As for trade creditors, they are typically unsecured and have the lowest claim in the event of any insolvency proceedings. Accordingly, they have little choice but to wait and see, often continuing business with the troubled company on a cash basis. It is recommended that a company be forthright with trade creditors about its situation, since lack of knowledge can increase the intensity of the dispute and subject the company to aggressive collection attempts.

§1:11 --Cost and asset reduction

A company in a crisis situation must make a serious effort to reduce costs to lower the company's "break even" point to a level that is consistent with current revenues. In most cases, staffing reductions are the quickest and easiest way to contain spending; however, the company must make changes in this area intelligently in order to be sure that it maintains adequate resources in those functional areas that are absolutely necessary to support continued growth and development of the business. For example, companies are advised to make cuts in administrative and other "non-essential" services as opposed to drastically reducing research and development ("R&D") personnel, since R&D will be needed to address current product issues and, hopefully, create new products that will put the business back on track. Other areas where savings may be realized include each of the following:

- Management staff is typically reduced substantially, often by as much as 50%. While some positions will necessarily be eliminated as redundant or unnecessary in light of the temporary contraction of the business, consideration should also be given to allowing managers to retain their positions while accepting a temporary decrease in compensation perhaps coupled with some sort of bonus arrangement tied to successful turnaround that will provide an incentive for valuable managers to remain "on board" rather than looking elsewhere for a more stable situation.
- Outlays that were "ordinary and customary" in the past should be carefully scrutinized and steps should be taken to implement and enforce controls. For

example, sales personnel should be required to justify all requests for travel and savings can generally be realized by carefully monitoring the consumption of office supplies and other overhead expense items (e.g., electricity and telephone services).

- Companies operating in multiple locations should consider consolidating operations, a strategy that not only reduce rental and associated costs of maintaining space that is not needed but also often results in economies of scale and reduction of the oversight burdens otherwise imposed on company executives. Consolidation should be done carefully, however, and the reasons should be explained to employees throughout the company who will typically be quite concerned that their location will be the next one to go. When closing locations in small communities where the impact on the local economy will be substantial an effort should be made to provide some level of support for displaced workers in order to minimize the risk of unsightly public relations issues on top of the company's other problems.

Cost reductions do not necessarily solve many of the problems that typically throw a company into a crisis situation, particularly when the problems are caused by events that are not directly related to the expense of operating the business (e.g., a sudden downturn in demand caused by problems in the overall economy such as a recession). The goal, however, is to buy time for the company to right itself and prevent rapid deterioration of the firm's valuable cash position. The time frame for seeing the benefits from these strategies will vary depending on the situation and, at least in some countries, the regulatory environment. For example, firms in Europe may be required to make lump sum severance payments to employees that are laid off as part of a downsizing and these outlays may actually exacerbate the cash problem for a limited period of time. The benefit, however, should be realized in future periods as the company's overhead is reduced. Local economic conditions are also a factor in any downsizing plan. If the situation in the area has deteriorated for a number of firms, the company may encounter difficulties in terminating its lease obligations, either by simply quitting the lease or finding a suitable sub-tenant willing to take on all or a portion of the lease expense of the unneeded space.

In addition to cost reduction, companies may be able to raise cash and reduce carrying costs by selling off unneeded fixed assets. The efficacy of this strategy for smaller companies is generally mixed, however, since most firms of this size have not had the cash to buy a large portfolio of fixed assets. Moreover, many of the assets that become expendable, such as computer equipment, usually have little value when sold into the secondary market, particularly if other companies in similar difficulties are also selling at the same time. Companies that have progressed to the stage where they have substantial inventories of products and parts may be able to dispose of those items, albeit at substantial discounts, to raise cash and conserve the working capital that would otherwise be required in order to cover the costs of carrying the inventory; however, if the firm has financed the purchase of inventories using funds made available by banks and other outside lenders those creditors will generally have the right to dictate how the proceeds received by the company will be used and typically will demand that most of the funds be used to pay down debt and that the terms of any large sale of assets pledged as collateral must be approved in advance by the creditors.

§1:12 --Employee morale

Deteriorating employee morale is inevitable during a crisis situation and will be an issue even in times when the company is relatively stable if the environment in which the company is operating is in disarray (e.g., a recession is gradually weakening the financial condition of one or more key customers or other business partners or threatening to tighten the availability of credit that the company was counting on to pursue an important business strategy). As noted above, one of the first treatments applied to a troubled company is payroll review followed by layoffs—often substantial reductions in headcount that cut across all divisions and departments. While senior management should be communities with the workforce regarding personnel moves many employees will have trouble understanding the “rhyme and reason” for how and why staffing cuts were made and while they may be grateful to retain their jobs, at least for the time being, the more likely response as time goes by will be feelings of vulnerability and stress coupled with fatigue from having to take on additional tasks that were formerly carried out by colleagues no longer with the firm. If attention is not paid to employee morale the company can expect a series of additional problems including declines in productivity, deterioration in manufacturing quality and customer service, increased sick days, reduced sales and higher costs even as overhead has been slashed and lower profits.

Of all things, regular and candid communication from management is probably the important step that can be taken to bolster employee morale during times of crisis. The CEO and other members of the senior management team should meet regularly with employee groups to discuss, openly and candidly, the challenges that the firm is currently confronting and explain the steps that are being taken to resolve the issues at hand. The substance of these discussions will often be uncomfortable for employees and may do little to alleviate their concerns about job security; however, employees deserve honesty rather than more surprises. An element that is often forgotten by management during these sensitive periods is that the employees who have survived the initial layoffs will be the foundation for the future of the firm and the way they are treated during a crisis will impact the long-term organizational health of the company—if employees are treated fairly and respectfully during troubled times they will be more loyal and more likely to trust the decisions made by the CEO and other executives. Senior management must also be mindful of the stress that has already been placed on the remaining employees when setting guidelines and expectations with respect to productivity and similar issues.

Obviously, the company must “do more with less”; however, there is a limit to how much time and energy can be extracted from employees before they will break and senior management must, as part of the turnaround plan, identify those activities where the company’s finite human resources can have the biggest impact in terms of profitability. A crisis situation, particularly one that occurs simultaneously to a number of firms (i.e., a recession) can actually uncover opportunities for the firm that were not apparent during periods in which resource allocation issues were so relevant. As part of the turnaround plan senior management should look for new areas that might be a better fit for the firm’s

remaining talent and turn those initiatives into entrepreneurial voyages that generate excitement among employees.

§1:13 --Relationships with business partners

As a troubled company executes its cost reduction strategies and scampers to reorganize its business operations to survive and move forward in a new direction, management must always be mindful of the need to monitor and regain the firm's credibility in the eyes of customers, suppliers and other important business partners. As with employees in this situation, the best prescription is communication with these important stakeholders, which generally starts with personal contact by the CEO and other members of the senior management team.

Ironically, a crisis is often the ideal time to critically evaluate each of the company's presumed "major" business relationships. In difficult times management should implement appropriate review and evaluation procedures to identify and measure default or delay risks in its arrangements with key business partners. Admittedly, such a system may be too little and too late when the crisis is triggered by problems with an important contract; however, it is an important discipline for the company to put in place since it will necessarily need to be quite selective in investing its limited resources in contractual relationships for the foreseeable future. The firm cannot afford any additional delays or cancellations under a sales agreement, nor can it absorb supplier delivery problems. As such, each new prospective project should be carefully analyzed by reference to issues or factors that have led to contract problems in the past and projects that carry the earmarks of trouble should be rejected at the outset.

§1:14 --Business strategy

As the firm in crisis sheds unnecessary or unproductive resources, it must simultaneously conceive, plan and implement new business strategies. At this point, radical changes are generally imprudent and, in light of the precarious resource situation, impractical and it is most common to identify one or more changes in business focus as the guiding principal beyond specific actions and tactics. A change in business focus typically takes the form of one or more changes in the products and/or markets that are targeted by the firm. In most cases, the firm should move quickly to narrow its focus to a handful of product or market segments that offer the best opportunities for the company to exploit its competitive advantages. Inevitably, this requires a hasty withdrawal from those markets that do not fit into the new strategic paradigm and which are simply not best suited to the firm's competitive advantages as they are defined after the changes necessary to respond to the crisis. While many companies simply close down activities in disregarded product and market areas, divestiture is the preferred method, if possible, since it avoids the costs of closure and may even raise some additional capital for the remaining business.

In situations where the firm is already positioned in the appropriate product or market segments, the change in business focus may actually take the form of developing and marketing new and improved "value added" products that can combat sales erosion

caused by product or price competition. Obviously, there are several ways to proceed to achieve these objectives, including improvements or enhancements to existing products that expand their functionality and perhaps combining one or more existing products into a new package that might be more marketable to prospective customers. For example, product manufacturers may bundle several of their own products, as well as other products licensed from third parties, to create systems that can then be customized and differentiated for particular customers and markets. Existing products or new systems may also be enhanced by offering additional service and support.

The firm may also attempt to address a deteriorating situation by shifting its position in the value chain. For example, the company may elect to move away from manufacturing products and become more involved in distribution activities. Another strategy is to de-emphasize direct participation in manufacturing through increased reliance on subcontractors. In addition, many companies seek to survive by developing and marketing a broader scope of services relating to their core technological and market competencies.

Finally, while crisis demands significant cuts in several functional areas in an effort to preserve capital and achieve positive cash flow, management of small growth firms must remain focused on the development of new products that will move the company forward into the future once the immediate problems have been resolved. Whenever possible, investments should continue into new product development projects that are carefully focused in the correct product and market areas. Projects that carry significant market and/or technology risk should be avoided at this stage and speculative, or “skunk works,” projects should be suspended for the time being as the firm must dedicate all of its available technical and scientific resources to products that have a clear and immediate market application. Project selection should also take into account the amount of time that will be required to complete the work, since the firm generally will have only a limited amount of capital available for survival.

§1:15 --Marketing strategies

Companies in crisis typically need to improve their strategies and activities in the marketing area. In many cases, the new CEO will take directly responsibility for marketing, since the CEO will necessarily be spending a substantial amount of time working with customers and dealers to restore and maintain their confidence in the firm. During those communications, every effort should be made to discover and understand the factors that drive the decisions of those parties with respect to purchasing the type of products and services offered by the firm.

The first thing that needs to be done in retooling the marketing strategy for a product or service is making sure that the seller effort is directed to the person or group within the customer organization that will actually be using the product or service. For example, firms often make a mistake by focusing their sales efforts on senior managers in the customer’s MIS function, as opposed to persons in other functional areas who will stand to benefit from the features and functions of the product. If the MIS manager is reluctant

to embrace a new technological solution or a small vendor, and also fails to understand the real world benefits of the product, the sales effort will not be effective. The key is to get the new product in front of the right customers within the buyer and have them make the case to MIS or other departments for purchasing the product. One way to demonstrate the real value proposition of the product to the customer is to allow the customer to use the product on a trial basis. In this way, the customer has an opportunity to directly observe the benefits that may be derived from the product in the context of the customer's own working environment.

The company should also examine its sales and promotional strategies to determine if they are delivering a clear and appropriate message regarding the value proposition of the company's products and services. For example, if the value of the new product lies in its reliability in performing functions and activities that are essential to the safety and security of the user, it is not prudent to construct a promotional campaign that is based on gimmicks that fail to convey the unique quality and performance aspects of the product. Again, steps should be taken to provide comfort to the prospective users about the new product, perhaps by convincing satisfied initial customers to provide testimonials about the product that would be meaningful and understandable to similarly situated buyers in other organizations.

Another area within the marketing mix that needs to be addressed is determining the appropriate pricing level for the company's products. Given the need to generate sales in a crisis situation, the common response of marketing specialists is to insist that prices be maintained at current levels or, in many cases, reduced to increase unit sales volumes and address price competition from similar products in the target market. Unfortunately, the new CEO often discovers that decisions about pricing are being made with little or no reference to the costs of manufacturing and, in fact, the price may be set at a level that virtually guarantees that money will be lost on each and every sale. Accordingly, it is essential for the CEO and other senior managers to quickly conduct a comprehensive assessment of the entire cost structure associated with each product and then set, which usually means increase, the price at a level where the firm has a reasonable chance to achieve profitability going forward. In many cases, the firm will find that, to the surprise of the marketing group, few new sales are lost even when prices have been increased by 50% or more.

Finally, time and attention should be paid to improving the management of the company's sales group and personnel. This requires not only greater emphasis on recruiting, training and motivating qualified and experienced salespersons, but also calls for a reassessment of the manner in which the sales group is approaching current and prospective customers. Added to each of these tasks at this stage, of course, is the need to reassure customers and build and maintain credibility as the company struggles to get back on track. Recruiting qualified salespersons during a crisis is a challenging job since the best candidates may be put off by concerns about the long-term viability of the company and the prospect of trying to convince customers to purchase products from a company that might not be around, and able to provide post-sale support, in a few months. Management must be prepared to design and implement innovative

compensation systems for its sales team to provide exceptional incentives and, just as importantly, allocate resources to customer service and launch marketing and communication campaigns to alleviate the aforementioned concerns of prospects. Of course, pricing obviously plays an important role in the sales dynamic and management must carefully scrutinize the cost structure associated with the company's products and set prices and sales compensation schemes in a way that accelerates profit generation while satisfying the legitimate expectations of talented sales professionals.

§1:16 --Manufacturing changes

Companies in crisis inevitably need to consider and implement changes in their manufacturing processes. In many cases, one of the fundamental problems for the firm is that the manufacturing process itself is poorly designed, resulting in manufacturing delays and poor quality output. In response, the new CEO often decides to go outside the firm to independent technical experts who can conduct a thorough review of the manufacturing process and make suggestions for short-term and long-term improvements. The downside of this approach, of course, is that the morale of current engineers and manufacturing personnel will be adversely impacted; however, in most cases they have had already had sufficient opportunity to remedy the problem and obviously have not been successful.

Another step that needs to be taken is establishing realistic and firm deadlines for delivery of products to customers. Not only does this require that the manufacturing process be reliable and predictable, it also calls for coordination with sales and marketing personnel to make sure that they are making promises to customers that correspond to the plans and resources in the manufacturing area.

Manufacturing costs can also be decreased significantly through careful and adroit use of outsourcing strategies. Many companies have been able to reduce fixed and variable costs through contracts with foreign manufacturers located in countries where both labor and materials are much less expensive than in the firm's domestic market. A related strategy is to improve the quality of the firm's existing outsourcing strategies, such as by reducing the number of vendors and instilling competition into the bidding process. Finally, another way to reduce manufacturing costs is to eliminate excess capacity that is no longer needed due to the unanticipated decline in sales volume.

§1:17 --Financial objectives

The CEO and other senior managers of a company in crisis must act quickly on a number of fronts to stabilize the business, reduce unnecessary cash flow and put the firm in a position to once again become competitive once the problems have been identified and resolved. This is a difficult task and management may often feel that there is no way to tell whether or not its responses are effective. One way to combat these feelings of anxiety and uncertainty is to establish at the outset certain financial goals and objectives for the turnaround process and to consistently measure the firm's progress against those guidelines. At this stage, the emphasis is necessarily on the financial health of the

business, as opposed to marketing and technical milestones; however, product development and sales activities will still be important expense and revenue items in any projections prepared for the turnaround period. Among the key performance factors that need to be tracked are the following:

- The firm should begin to experience dramatic sales growth between 12 and 24 months after the beginning of the turnaround plan. Profitability should be achieved more quickly, typically within six months after the beginning of the turnaround plan.
- The debt level of the firm should be reduced significantly during the first year after the beginning of the turnaround plan. A number of factors are at work here, including the reluctance of lenders to advance funds to the troubled company; however, debt reduction follows from aggressive negotiations between management and outsiders that have extended credit to the business in the past.
- The return to profitability should allow the firm to begin expanding its fixed asset base since funds will be available in for investment in assets necessary to pursue key projects, including new product development and improvements in manufacturing capabilities.
- Inventory levels should be decreased significantly within 12 months after the beginning of the turnaround plan. The goal is to free up the working capital needed to support the storage and maintenance of excess inventory and, in many cases, to generate additional cash by liquidating the unneeded inventory.
- Performance with respect to the collection of receivables, as measured by reduction in debtor days, improves substantially within six to 12 months after the beginning of the turnaround plan and, significantly, remains under control during the later stages of the plan. Continuous control of receivables follows from the efforts to build and maintain the confidence of customers who might otherwise be reluctant to pay vendors experiencing financial difficulties.
- Satisfaction of payables, as measured by reduction creditor days, also improves during the first 12 months after the beginning of the turnaround plan. Not surprisingly, firms are more likely to be successful in a turnaround situation if they have been able to avoid materially extending payables as the crisis situation builds.

Plans based on successful improvement in each of these financial- and accounting-based areas can often be implemented quickly before new management has an opportunity to make a detailed analysis and assessment of specific product, technology and market factors. In fact, it is common for experienced turnaround experts to arrive at their new companies armed with a standard menu of tightening financial controls, asset and cost reduction and refinancing that goes into place on the very first day of the new regime.

§1:18 --Financing strategies

There are a number of financing strategies that a troubled company can adopt, including arranging bridge financing until conditions improve, and issuing promissory notes with warrants. However, it is likely that senior managers and existing investors will be forced to absorb substantial dilution of their ownership interests in the company and that funding sources will require a relatively rapid turnaround of company fortunes. New funding is

typically accompanied by requirements that the company take drastic steps to reduce the amount of cash expended for operations.

Bridge financing is primarily intended to keep the company operating until additional equity funding is secured or the company is able to achieve profitability. As such, a bridge loan is short-term and often calls for repayment within six to nine months after the funding. Alternatively, the loan may be due on “demand” by the investors (*i.e.* a demand note), with the informal understanding that the loan will not be called for some minimum period of time or a project is completed. Investors generally also insist on the option to demand repayment when outside funding is received by the company; however, in most cases, the investors will be willing to allow the outstanding principal and interest to be converted into the equity securities issued, but at a discounted conversion rate as a reward for taking on the risk when the company was in trouble.

If the bridge loan is not paid off when due, the bridge loan investors will generally have the right to convert their loans into common shares of the company at extremely favorable conversion rates, thereby significantly diluting the ownership interests of the founders and managers. Rather than convert, investors may be willing to extend the term of the bridge loan and bring in others to provide additional funding; however, such a scenario generally requires that the company agree to collateralize the notes with assets and grant the new investors a security interest.

The bridge loan is generally a fixed amount; however, the parties may agree that the company may determine the amount of the loan up to a specified maximum by requesting advances over the term. The amount is strictly tied to the minimum cash requirements of the company during the term that the loan is outstanding. In some cases, the proceeds of the bridge loan will be used to fund a specific project, such as completion of the development of a new product or service. In other situations, the loan will offset anticipated shortfalls from operations until the company is able to achieve profitability or secure outside funding. A bridge loan is often accompanied by investors’ rights agreements regarding management of the company, with investors demanding control of the board of directors as a way to ensure that the bridge funds are being properly utilized.

A bridge line of credit arrangement is an interesting variation on the basic bridge loan. Rather than distributing a fixed amount of funds to the company at a single time, investors in a bridge credit line will agree to make funds available for use by the company during a specified period. The company may choose to draw down all or a portion of the available funds or opt for alternative sources of funds. Funds drawn down will bear interest at a rate agreed on by the parties and must be repaid on a fixed date in the future. The company may elect to repay any portion of the funds drawn down from the line of credit and may re-borrow funds on the same terms during the availability period. Like a basic bridge loan, the term of a line of credit arrangement is relatively short, generally less than 12 months. If the company is unable to repay all advances, the investors will have the same conversion rights that apply in the case of a bridge loan. Even if the company does repay the advances, or never uses the line of credit, it is common for the investors to receive some compensation in much the same way a bank

charges a commitment fee. The compensation usually takes the form of warrants or options to purchase equity securities at favorable prices in the future.

A line of credit arrangement has certain advantages to the founders and managers over a basic bridge loan. First and foremost, it allows them to limit the dilution on loan conversion. In theory, if the company can avoid the need to draw down funds, or can repay the funds out of operating capital prior to the next round of financing, there will be no requirements that the available funds be converted into equity securities. Second, a line of credit from investors can be used to show other funding sources, including investors and commercial lenders, that the company is solvent and has access to operating capital. Absent a line of credit, prospective investors may drive a harder bargain based on the poor financial condition of the company.

Where the company is having trouble persuading borrowers to take a promissory note, it may have to issue a note and warrant purchase agreement. In the absence of the warrant, investors can only expect a fixed return on their investment (*i.e.* return of principal plus the agreed amount of interest). By receiving warrants, investors can participate in any upside that may result from the use of funds. The number of warrants is referred to as the “warrant coverage.” The type and number of securities that may be issued upon exercise of the warrant is determined by negotiation, and the total exercise price of the warrants usually bears a fixed percentage relationship to the amount of funds loaned to the company. For example, in the case of 20 per cent warrant coverage, the total exercise price of the warrants would be 20 per cent of the principal amount of the loan by the investors. If the investors loaned \$1 million and received warrants to purchase common shares at a price equal to the then-fair market value of \$1.00, the total number of shares issuable upon exercise of the warrants would be 200,000. Obviously, as the level of warrant coverage increases so does the “cost” to the holders of existing equity securities in terms of the potential dilutive effect.

§1:19 Managing and prospering during recessionary periods

It is a difficult fact of life that troubles may arise due to factors that are largely outside the control of the management team including economic downturns (*i.e.*, a long-running recessionary period such as what the US has experienced several times during the opening years of the 21st Century). Managing and prospering during recessionary periods requires many of the skills and processes mentioned elsewhere in this Guide regarding management of troubled companies and firms in crisis. Of course, if a recession causes a crisis for a firm the reaction should be appropriate for the situation; however, if a company identifies a looming economic downturn it should move proactively to seize a potential problem as an opportunity to solidify existing advantages and cash in on opportunities that may arise while less prepared competitors struggle and abandon resources, markets and initiatives that would otherwise have made them more formidable in the future.

Two partners from the Boston Consulting Group writing in the Harvard Business Review⁵ provide the following clear advice as to steps that management should take to “seize advantage in a downturn”:

- The first step would be evaluate how vulnerable the company might be in a downturn including scenario analysis (i.e., charting out how the firm would be impacted based on different scenario regarding the severity of the downturn), quantification of the impact on the company’s business and assessment of the vulnerabilities of competitors.
- The second step would be initiating actions to maintain liquidity and financial strength including monitoring and maximization of cash position, increased vigilance over customer credit practices, aggressive management of working capital and improvement of firm financial structure (e.g., reduction of debt and other liabilities while securing access to additional lines of credit that can be used during the downturn period to take advantage of opportunities).
- The actions relating to liquidity and financial strength should be accompanied by implementation of strategies to stabilize and strengthen the current business including cost reduction and increased efficiency/productivity, aggressive management of to-line revenues, analysis of product mix and pricing strategies and enhanced vigilance of investment and diversification strategies (e.g., establishment of stringent capital allocation guidelines and divestment of unproductive assets and non-core businesses).
- Once the steps describe above have been mapped out and implementation has commenced full attention should be placed on identifying and exploiting opportunities that will arise during the downturn which means thoughtful investment for the future, pursuit of opportunistic and transformative acquisitions and reassessment of existing business models.

The writers recommend that companies adopted many of the same management practices during a downturn that they would during any other crisis situation including creation of a dedicated “crisis management team” to formulate and implement the company’s response to the current or expected recession. This team would take the lead in scenario analysis and developing and prioritizing initiatives referred to in the list of steps outlined above. The team should provide a valuable safeguard against what the writers refer to as the “snags of implementation” including insufficient understanding and appreciation of the evolving crisis, lack of preparation and commitment among members of the senior management team, failure to see how individual initiatives taken in response to the downturn fit within an overall comprehensive plan and a lack of attention to continuously communicating with middle managers and employees about how the firm is responding to a situation that certainly creates stress within the workforce.

⁵ The discussion in this section is adapted from D. Rhodes and D. Stelter, “Seize Advantage in a Downturn”, Harvard Business Review (February 2009), 50-58.

Chapter 2

Crisis Management

§2:1 Introduction

Recent events, from terrorist attacks to widespread product defects to man-made natural disasters to disclosures of illegal and unethical activities among senior executives at well-known, high-profile companies, have led to enhanced emphasis on the art and science of “crisis management.” A crisis may be defined in a variety of ways; however, when used in the business planning and operations context, the term refers to an event or occurrence (or a related sequence of events or occurrences) that is unplanned and unforeseen and which can reasonably be expected to have an undesirable and adverse impact on a company and its business activities. The list of possible events or occurrences that meet this definition is almost endless and includes such things as natural disasters, terrorist attacks, workplace violence, litigation and government investigations, labor problems, product defects, sudden death or other loss of key personnel and financial problems—and the involved parties can include such well-known firms as Johnson & Johnson, BP, Toyota and Goldman Sachs. While, in hindsight, many crisis events would appear to have been foreseeable, the reality is that most companies are caught totally by surprise or, at best, lack sufficient notice to take adequate precautions. However, given that such events pose significant threats to business and their physical and human assets it is imperative that some effort be made to plan for dire situations in advance.

§2:2 Risk factors for potential crisis situations

Any and every business is vulnerable at some point in time to an unforeseen crisis situation. There are, however, certain factors and conditions that identify businesses that are particularly at risk, including the following:

- Businesses that have recently suffered some type of crisis tend to be more vulnerable to additional problems in the immediate future. There are a variety of reasons for this phenomenon, including the probability that the organization was unprepared for the situation that created the initial crisis and the fact that management is probably preoccupied with dealing with the first set of problems.
- Businesses that operate in highly regulated industries are more likely to encounter high stress and high profile situations that can cause substantial damage to the business and reputation of the company. For example, such firms may become the target of well-publicized government investigations, product recalls and/or consumer protests.
- Businesses in the midst of financial difficulties, notably cash flow shortages, are obviously more likely to encounter major problems with key stakeholders, including suppliers, lenders, investors and employees. Without careful management, the firm will not only dissipate its goodwill with the stakeholders, it may find itself forced into legal proceedings and unable to continue production and overall operations.

- Businesses with “high profile” executives or involved in well-publicized new product markets are always subject to higher scrutiny and, as such, will likely be more quickly scrutinized and criticized in the event of a misstep.
- Particularly after the massive regulatory changes in the last few years, public companies have become much more vulnerable to a crisis than in the past. In addition to the extensive new regulations promulgated by the Securities and Exchange Commission and many state securities regulators, public companies and their managers must contend with greater scrutiny from outside investors, analysts, the financial press and independent accounting firms subject to their own new set of oversight controls.
- Start-up businesses and emerging companies (i.e., firms that have survived the start-up stage and entered a period of rapid growth in immature technological and project markets) are generally ripe for crisis. Start-ups obviously suffer from a lack of resources to deal with all the issues and constituencies that must be addressed to successfully launch a business. Emerging companies, while presumably less risky than start-ups due to their early success, are nonetheless still overwhelmed with keeping pace with rapidly changing markets and the need to add new resources at a breathtaking pace, which means that there is little time for identifying and mitigating potential crisis risks.
- Successful businesses, particularly those with high market share in their chosen industries and market sectors, are at risk given the likelihood that they will be subject to greater scrutiny in the event of a misstep, even though their business strategy and internal controls are likely to be sound.
- Companies that operate under stressful and otherwise poor working conditions are more likely to experience a crisis in the workplace, including employee violence, insubordination and high turnover rates that increase marginal costs of production.
- The inability or unwillingness of the principal owners to be actively involved in the operation of the business on a day-to-day basis increases the possibility that a crisis will arise due to poor performance of the onsite managers or lack of adequate controls. Moreover, once a crisis crops up, continued absence of the owners makes it more likely that the problem will not be solved since the owners cannot assess the situation and the remedial actions for themselves.

Given that almost every business can recognize itself as falling into at least one of the categories listed above, each company should carefully consider the need to incorporate formal crisis management planning into its overall operations scheme, either as part of its corporate governance and legal compliance programs or as a separate initiative that is undertaken with the advice and participation of the legal function.

§2:3 Crisis management plans and programs

It is essential that companies adopt and maintain an integrated approach to crisis management, which means that provision must be made for effective coordination of activities prior to, and during, any crisis. The first step in preparing for a crisis is development of a crisis management plan or program approved by senior management of the company to identify those persons within the organization who will have managerial

responsibilities with respect to each area; devise a clear set of procedures and instructions to be followed in the event of a crisis; and ensure that the business continues to operate during and after a crisis. While the form and content of the plan or program will vary substantially depending on the type of business and the key risks confronting the specific company, consideration should always be given to addressing several key areas including management responsibility and accountability, compliance, preparation, training and education, communications, management and protection of information, contract management and planning and insurance.

In addition to the written crisis management plan or program, companies will generally prepare a number of specific procedures focusing on particular aspects of responding to a crisis situation. For example, a crisis communications plan should be developed to ensure that the crisis management team is able to communicate during a crisis and employees and other stakeholders are able to have access to news and information that the team wishes to disseminate during a crisis. An incident management checklist should also be created that lays out the steps that need to be taken during the response period and lists all of the activities that need to be completed within each key functional area of the business. In addition, the company should formalize customized procedures for specific types of crisis situations, such as a civil disturbance. Also, while many crisis situations are difficult to predict, the plan or program should include tools for continuously surveying and monitoring the company's external environment to identify threats in advance and, if possible, mitigate risks before an event overcomes the organization. In many cases, an outside consultant is used to identify specific types of risks, such as the existence of hazardous materials, and recommend strategies for remedying any actual or potential problems.

§2:4 --Management responsibility and accountability

In order for a crisis management plan or program to be effective, senior management and the board of directors must create a formal organizational structure that vests authority for the plan or program in a senior manager and makes that manager accountable for the results of the plan or program. For example, the company may designate a Director of Crisis Management Programs and provide that person with the resources to accomplish each of the other activities listed above. A job description should be created for the position and goals and objectives should be established to measure and reward performance. The designated manager should be required to prepare a formal crisis management plan and associated budget and deliver regular written and oral reports directly to the chief executive officer and the board of directors or a designated committee thereof (e.g., audit committee). In addition, the designated manager will be responsible for organizing and training the core crisis management response team.

§2:5 --Compliance

The crisis management plan or program should be integrated into the company's overall legal and regulatory compliance program since a number of businesses fall into a crisis situation due to problems caused by failure to adhere to applicable statutes and

regulations. The compliance process begins by identifying all the statutes and regulations that pertain to the operations of the company and then measuring how well the firm is doing with respect to compliance. While it is important to comply with every law, the emphasis of the crisis management group should be on potential violations that could escalate into a situation that could materially damage the firm or result in great harm to people or property. Environmental and safety issues immediately come to mind; however, as legislation has overtaken areas such as corporate governance, the range of potential compliance risks has expanded substantially.⁶

§2:6 --Preparation

It is too late to prepare once a crisis occurs; accordingly, preparation is a key element of a crisis management program. In the broadest sense, preparation includes not only creating a plan to be followed once a crisis occurs, it also extends to efforts to prevent and mitigate crisis situations. Activities in this area should include preparation and dissemination of crisis management procedures to be followed during a crisis; development of tools for detecting and quickly evaluating the severity of a crisis; and development of strategies for facilitating the "recovery" of the firm after a crisis has occurred. Preparation is obviously closely tied to compliance and training, and companies often rely on outside consultants to assist in devising strategies in this particular area.

§2:7 --Training and education

Companies are best prepared for a crisis when those involved have been given appropriate training and education about the situation and the manner in which they should respond. The first level of training and education will be for those persons designated as members of the crisis management response team. They need to understand their role and responsibility at the time a crisis occurs, including the chain of command and how to get and disseminate information about the crisis. Beyond this, a regular program of education should be made available to all employees of the company so that they have a basic understanding of what they need to do, and what will happen, in the event that certain crisis situations erupt. While companies certainly should lay out their crisis management procedures in formal policies and employee handbooks, the most effective communications are through lectures, demonstrations and even actual drills and exercises. Outside consultants are often used to view and evaluate the level of education and awareness within the company. Training and education should be tailored to the risk profile of the business; for example, companies in the southeastern part of the United States should focus on dealing with weather-related disasters.

§2:8 --Communications

⁶ For further discussion of compliance programs and related issues, see "Compliance and Risk Management: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

Communication, both internal and external, is a key issue during a crisis situation, and the crisis management plan or program should designate a particular senior manager and/or department to handle communications issues. Among other things, provision must be made for development and dissemination of internal and external communications during a crisis, coordination of all communications to the media and review and approval of all statements relating to the crisis. Special care will need to be taken in communicating with employees and key business partners, since those groups require assurances about the company and its operations following a crisis. In most cases, communications procedures in the event of a crisis are deemed to be so important that the company will develop and disseminate a separate written crisis communications plan.

§2:9 --Management and protection of information

Formal procedures should be established for management and protection of information relating to the crisis management plan and, of course, the facts and circumstances of any actual crisis and the response of the company thereto. In contemplation of litigation following a crisis, the company should document all the steps taken to identify potential risks and protect the company and its stakeholders from substantial harm. In addition, the information system should include a record of all commitments made by outside responders and activities taken to train and educate employees about crisis situations. The information system should include everything necessary for the company to respond to a crisis and steps should be taken to protect that information and ensure that it can be accessed even if the company's day-to-day IT operations have ceased to function during the crisis. Finally, all parties responsible for the crisis management program must continuously monitor the relevant databases to make sure that information is kept current.

§2:10 --Contract management and planning

An often forgotten, yet potentially important, element of crisis management planning is negotiation and drafting of the procedures to be followed under key company contracts should an unforeseen event occur that makes it difficult or impossible for one or both of the parties to perform their duties and obligations under the contract. Typically, contracts include the boilerplate language used in most "force majeure" clauses that excuses the parties from their duties during any period that performance is rendered impossible due to an "Act of God" or the outbreak of wartime hostilities. Counsel should consider reviewing the company's standard provisions to take into account other potential risks, including terrorist acts and natural disasters. In addition, careful thought should be given to the possibility that problems suffered by third parties not subject to the main contract might make it difficult for the company to perform its obligations.

§2:11 --Insurance

Senior managers responsible for the company's crisis management planning and preparation must continuously evaluate available insurance coverage to determine whether or not the company is adequately protected. As the number and nature of risks confronting any business expands, insurance carriers are making substantial changes in

their policies, and premiums for coverage of certain types of risk have risen significantly. In addition, before a new policy can be issued for a particular risk, insurance carriers may impose numerous conditions on a prospective insured, including implementation and maintenance of a crisis management plan or program.

§2:12 Identifying and remedying weaknesses in crisis management planning

Once the crisis management plan or program has been developed and implemented, the person with management responsibility must continuously monitor performance and remain vigilant against the following common weaknesses in this area:

- The lack of a formal plan and procedures for systematically collecting and organizing all of the information relevant to the crisis management function. In order for the plan or program to be effective, the company must continuously conduct risk analysis and obtain current information on relevant regulations and business conditions.
- Failure to disseminate, or otherwise communicate, information regarding the plan or program to all interested parties within the organization. The responsible manager should be sure that all necessary policies and guidelines are widely available throughout the company and that training and education occurs before, and not during or after, a crisis.
- Failure to identify the appropriate chain of command and responsibilities in advance of a particular crisis. Authority should be established in advance of a crisis, since there is no time for indecision once a crisis erupts. Similarly, the duties and responsibilities of each person within a “crisis period” organization should be clearly delineated in advance.
- Poorly organized information that makes it difficult, if not impossible, for managers and employees to understand the plan or program and their responsibilities in relation thereto. When a crisis occurs, there is generally no time to search through voluminous information, regardless of how useful it might be, to find the answer to a simple question. Materials should be “user friendly” to facilitate easy reference and, just as importantly, pre-crisis training and education.
- Failure to disseminate the information to outside parties who would be key responders in the event of a crisis. The responsible manager should be sure that appropriate outside parties, including consultants and governmental authorities, are advised of the plan and their projected role. If necessary, outside parties should participate in ongoing training and evaluation of the plan or program to be sure that their roles are adequately defined and understood.

While the responsible manager can analyze each of the issues listed above, it is generally useful to obtain an independent assessment from an outside consultant or advisor that specializes in crisis management and the related planning. Internal monitoring can become increasingly difficult as time passes since the lack of a crisis tends to reduce the initial sense of urgency that inspired the development of the plan or program in the first place. By obtaining an outside opinion, the company can have a higher degree of comfort that something has not been overlooked. Moreover, outside consultants should be able to provide the firm with information about new state-of-the-art tools for

monitoring the environment and dealing with specific types of crisis situations. Continuous monitoring also ensures that the plan will be updated to take into account changes in important information, such as contact information for government agencies.

§2:13 Governance practices in troubled times

In addition to the business and operational issues discussed above, directors and senior officers of the company must be mindful of unique corporate governance issues that arise in times of trouble for their firms. The directors, as well as the senior officers, of every corporation have specific duties with respect to identifying and managing the risks associated with the business activities of the corporation. Under state corporation laws, for example, directors and officers must satisfy their fiduciary duties of care and loyalty and this generally means that they are required and expected to exercise reasonable judgment in overseeing the activities of the corporation by, among other things, developing internal reporting and monitoring systems that will allow them to keep abreast of material risks. Once a material risk has been identified the directors and officers must exercise their good faith business judgment to manage those risks in an informed and disinterested manner. In addition, Section 404 of the Sarbanes-Oxley Act places explicit burdens on the leaders of public companies to regularly assess the effectiveness of their internal controls and stock exchange requirements, such as those mandated by the New York Stock Exchange (“NYSE”), require that members of the audit committee of any listed company must discuss the company’s policies with respect to risk assessment and management as well as the company’s major financial risk exposures and the steps management has taken to monitor and control such exposures. It should be noted that the NYSE rules include a comment that the actions of the audit committee should not replace other mechanisms used by listed companies to manage and assess their risks and that the chief executive officer (“CEO”) and other members of the senior management team are expected to take the lead in this area. Finally, any actual or perceived failure with respect to risk management will likely expose the company and its directors and officers to intense scrutiny by the media and the financial community that may substantially damage the reputation of the company, impair its ability to obtain additional capital and trigger inquiries from the Securities and Exchange Commission (“SEC”) and other regulators.⁷

When a corporation runs into trouble based on what appears to be, in the perfect light of hindsight, a failure to anticipate and manage a material risk the directors are themselves vulnerable to a claim that they breached their duty of loyalty by failing to act in good faith in taking steps to identify and manage risks and/or consciously disregarding warning signs that suddenly appear to be so clear once the damage has occurred. The business judgment rule can provide directors with a “safe harbor” absent a showing of a breach of fiduciary duties; however, in order for the rule to be of value to directors they must establish in advance a record that they have acted in good faith and in the honest belief that their decisions were in the best interests of the corporation and its shareholders. Given the volatility of business and financial markets, which means that a new and

⁷ For further discussion of the various fiduciary duties of corporate directors and officers, see “Governance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

apparently unforeseeable crisis can arise at any moment, it is imperative for directors and senior officers to act immediately to review and shore up their risk assessment and management policies and procedures. This advice applies even to those corporations that believe they have already done enough since any failure to explicitly and formally acknowledge the tremendous uncertainty in the environment might in and of itself be viewed as a questionable governance practice. Another complicating factor for corporations that fall into dire financial condition—referred to as the “zone of insolvency”—is the additional fiduciary duties to creditors as well as shareholders, a topic that is discussed below.

Every industry has its own unique array of risks and no advice can cover all situations; however, given general economic conditions, and particularly the problems in the financial and credit markets, directors and senior officers should begin by regularly and carefully monitoring risks that might impact the ability of the company to maintain liquidity and access to capital needed for the business to survive and hopefully expand in the future. Directors and senior officers should anticipate that is highly likely, even for the best companies, that cash flow will be slowing down and that for the foreseeable future debt and equity capital will be unavailable or available only on terms that are prohibitively expensive. As such, it is recommended that directors and officers should review and update the company’s operating and business plans, establish performance monitoring procedures, analyze the availability of short- and long-term capital, evaluate the condition and prospects of key business partners, analyze and upgrade disclosure and communications practices and procedures and evaluate and improve corporate governance practices.

§2:14 --Operating and business plans

The first thing that the directors should do is order the CEO and the other members of senior management team to immediately conduct a thorough review and analysis of the company’s near-term operating and business plans—covering the next 12 to 36 months—to identify potential issues relating to liquidity and capital requirements. The analysis should be based on the most current data and all assumptions should be rigorously tested so that several possible scenarios are placed in front of the directors for discussion. This is the time for the senior officers to be creative and brutally honest with themselves about adverse events that might occur within their specific functional area of responsibility. For example, the chief financial officer (“CFO”) needs to consider what might happen if credit rating agencies suddenly downgrade the company’s rating and the senior officer in charge of sales should look and see how economic conditions are likely to impact the buying behavior of major customers (or groups of customers). Companies that have direct and indirect exposure to so-called “toxic” financial instruments need to determine how developments in this area will impact their balance sheets. All departments and business units need to look at how systematic liquidity issues might impact their operations—will key vendors provide revolving credit arrangements, will the company need to adjust payment terms for large customers, what options are available for accessing short-term credit and/or investing excess cash? Given the rise of globalization it is likely that economic conditions in many foreign countries will also need to be

evaluated since companies now regularly sell into foreign markets and rely on foreign business partners for raw materials, components and outsourced business services.

It is likely that the operating and business plan review will uncover areas where revisions are necessary. The CEO and other senior officers should highlight specific issues that are of the greatest concern and propose changes to the plan that can mitigate the foreseeable material risks confronting the company. Among the options that should always be considered, although not necessarily implemented in each case, are cash preservation and cost reduction programs; classification of proposed capital expenditure programs into “essential” and “discretionary” and reallocation of scarce resources in accordance with those classifications (i.e., discretionary spending will be deferred and resources related to those programs will be channeled to other areas or, in the case of personnel, laid off); and identification of alternative sources of supply for key goods and services if there is a concern that current vendors may not be able to meet the anticipated requirements of the company. The decisions that must be made can be difficult and priorities must be set and honored by the directors and senior officers. For example, while it may be tempting to use available cash to repurchase company stock at what have become “bargain prices,” that capital may be better used as a war chest that can be accessed if credit markets continue to struggle beyond the danger period assumed in the plan. Senior officers must also set aside their personal interest in additional compensation to save cash and avoid unnecessary negative publicity.

§2:15 --Performance monitoring procedures

Once the operating and business plan review has been completed, and appropriate changes have been made to the plan, the directors should direct the CEO and the other senior officers to establish programs and procedures for continuous monitoring the performance of the company using the most current information possible. The monitoring program should extend beyond internal performance indicators to include all relevant factors in the company’s business environment including general economic conditions, financing and credit markets and the health of the business activities of the company’s key business partners and competitors. Provision should be made for regular and prompt reporting of material developments, particularly substantial and unforeseen variances from the plan, to the directors (or a specific sub-group of directors designated by the entire board) along with a description of the potential consequences and the various steps that the management team is considering in order to mitigate any new risks to the business activities of the company. Monitoring cannot be confined to developments in the domestic market and must include all key foreign markets. For example, if major manufacturers in Asia announce plant shutdowns the impact of these developments should be considered not only from the supply side, if applicable, but also in relation to dampened demand for the company’s products in Asian markets.

§2:16 --Availability of short- and long-term capital

While liquidity issues are an important part of the above-described review of the company’s operating and business plan a separate analysis should be done on the

projected availability of short- and long-term capital to execute the plan and strategies should be developed for seeking and obtaining alternative sources of capital. One of the first things that should be done is a review of the company's current debt and credit agreements to identify any potential compliance issues with respect to covenants and payment obligations. Particular attention should be paid to provisions that allow lenders to adjust credit terms, suspend additional borrowings or even terminate the agreement can call the loan for immediate repayment. The CFO should carefully evaluate the company's ability to meet its obligations under these agreements. A similar process should be followed with any other agreements that include the extension of credit to or by the company including contracts with suppliers that have traditionally allowed the company to pay for goods and services 30, 60 or even 90 days after taking delivery. If actual or potential problems are discovered the company should consider contacting lenders (including other lenders that might have the right to call their loans under cross-default provisions) as soon as possible to amicably negotiate some form of workout. If that is necessary the revised operating and business plan that should have been developed by the senior management team will be a useful tool in persuading lenders that the company has a good handle on managing its financial situation. Even if the company does not have an immediate compliance issue under its existing credit arrangements the CFO should identify and communicate with other potential capital providers since there is no guarantee that the company's existing lenders will continue extending credit even to their best customers.

§2:17 --Business partner evaluation

The operating and business plan review discussed above should include collection and evaluation of information on each of the company's key business partners in order to assess whether they are in a position to continue their current and projected volume of business with the company during the planning period. As part of that assessment a review should be performed of the existing contractual arrangements with those partners to confirm the duties and responsibilities of both parties and identify any specific milestones or performance conditions that might be at risk of being defaulted upon by either party. For example, if the company has appointed another party as an exclusive distributor of the company's products in an important territorial market a review should be made to determine whether the distributor will be able to satisfy any minimum sales requirements that should have been imposed as a condition to exclusivity. If it appears that the distributor will have problems fulfilling its obligations plans must be made for identifying and establishing new distribution channels in that market. Joint venture arrangements should also be reviewed to determine whether partners can continue to fill their obligations. In many cases the governance provisions in the joint venture agreement will permit a shift in voting rights or allow one of the parties to terminate the venture and put their equity interest to the other party.

§2:18 --Disclosure and communications practices

All companies, particularly listed companies, must seriously consider disclosure and communications practices and procedures as they go through their plan review process

and make adjustments to accommodate turbulent business and financial conditions. For listed companies this means understanding and complying with the detailed disclosure requirements under the federal securities laws with respect to risk assessment and management in general and liquidity and capital resources specifically. When filing their annual and quarterly reports with the SEC listed companies must include a detailed discussion of liquidity and capital resources in the management discussion and analysis (“MD&A”) section and interim changes in the company’s liquidity profile need to be disclosed in Form 8-K filings. SEC requirements regarding the MD&A should be carefully reviewed and followed and particular attention should be paid to changes that may have been made in forecasts that the company may have issued in previous reporting periods. Stock exchange regulations and state laws should also be consulted to determine if they create additional disclosure obligations. While the entire board, and the audit committee in particular, should be carefully monitoring the company’s public disclosures increased vigilance is necessary in a time when external changes are occurring on an almost daily basis and additional resources should be assigned to collecting and evaluating the information that would serve as the basis for the required disclosures.

Compliance with SEC and exchange reporting requirements is just one element of the company’s overall communications strategy and it is essential for the company to develop and implement a comprehensive plan for communicating with its key stakeholders including customers, vendors, investors, regulators, the general public and, perhaps most importantly, employees. With respect to the investment community one of the main concerns is that unfounded rumors regarding the business and financial condition of the company will play havoc with the company’s stock price. Certainly the disclosures made to investors should be accurate and bad news should not be withheld when the circumstances warrant disclosure; however, special care should be taken to keep analysts fully informed and monitor all news sources to identify and remedy misinformation regarding the company. In addition, the CEO and senior officers of each of the key functional departments and business units should reach agreement on a common communications message that can be used in discussing the company’s condition and prospects with interested parties. Meetings should be held with employees to update them on company affairs and answer any questions they might have about business strategy and plans relating to personnel, including layoffs and reduction in compensation and/or benefits. Discussions should also be initiated with key customers and vendors about possible restructuring of contractual arrangements and procedures should be implemented to ensure that each side remains informed about new events. This is the time when a professional communications advisory firm might be used to assist company representatives in dealing with the unfamiliar issues that arise in times when the company enters a crisis situation.

§2:19 --Corporate governance practices

When the company is involved in a crisis management situation, the directors and senior officers should launch a thorough review of the company's corporate governance practices, including internal controls and risk assessment/management processes. The review should be done in conjunction with outside professional experts from the legal

and accounting areas and should include refreshed training for the directors and senior officers regarding their fiduciary obligations and the need for them to think and act responsibly in their formal deliberations and in their communications with interested stakeholders as attempts are being made to address financial and operational issues.

Specific consideration should be given to whether or not the directors and senior officers are meeting frequently enough to evaluate information and engage in face-to-face dialogue regarding the strategic and legal issues that might be confronting the company. Failure to regularly deliberate on these matters might later be construed as a breach of the duty of due care and expose the directors to potential liability from shareholder actions. Experienced legal counsel should be asked to provide guidance on the processes that the directors should follow and the particular issues that need to be addressed. In particular, directors should be sure that they have access to all relevant information including regular reports on feedback that the company may be receiving from customers, suppliers, regulators and shareholders. This may be the time for additional meetings with company attorneys and accountants in order to be sure that directors are receiving candid and independent assessments of the progress of the steps taken to address crisis-related issues. Attorneys can and should also advise the directors on the contents of current contracts to which the company is a party and steps that can be taken to modify the terms of contracts to manage risks and cushion the company against potential liabilities associated with actual or anticipated failure to perform.

With respect to formal meetings of the board of directors, care should be taken to ensure that the records of their deliberations clearly document that the directors acted prudently and had a good basis for all of their decisions in order to preserve the protections of the business judgment rule. Directors should have access to all relevant information and should set aside the time to carefully review the information and thoroughly discuss each of the alternatives that might be available to the company. Some legal advisors counsel the directors to impose tight approval requirements on senior management as a means for making sure that the directors are kept “in the loop”; however, such measures must be balanced against the practical needs of the business and should not unduly hinder the ability of the officers to act quickly in order to keep the business moving consistent with overall strategic goals and targets established by the board and regularly reviewed.

Finally, directors should also be made aware of limitations of exculpatory provisions in the company's charter documents and the scope of available protection under the company's directors' and officers' liability insurance coverage. Indemnification provisions should be reviewed by legal experts and qualified and experienced insurance brokers should be brought in to make presentations to the board regarding current coverage and additional steps that might be taken in the insurance area.

§2:20 --Directors and officers responsibilities in the “zone of insolvency”

Unfortunately, the strategies for managing troubled companies are often not successful. Even a promising idea or technology may fail due to circumstances outside the control of management, such as a general downturn in economic conditions. Whatever the reason, a

company may reach the point where it is “insolvent.” While statutes and case law provide detailed explanations and examples of just what constitutes insolvency, the two key questions are can the company pay its debts as they fall due and do the assets of the company exceed its actual and contingent liabilities? If the answer to one or both questions is “no,” consideration must be given to one of several insolvency procedures (e.g., workouts, managed reorganization in bankruptcy or liquidation), as well as satisfaction of special duties and obligations imposed on the directors of insolvent companies. Obviously, this is not a good, or necessarily satisfying, time to be a director of the company. In fact, it is likely that management and outside directors will be at odds regarding the reasons for the deterioration of the business. Moreover, creditors, anxious to recoup some portion of the financial commitment made to the company, will be pressing for speedy resolution and directors will be disadvantaged in negotiations with prospective purchasers for company assets. The board should seek the advice of an attorney with experience in handling insolvencies during this period. Such an advisor can often provide perspective and may have relationships with the lawyers representing the interests of creditors.⁸

The threshold issue, of course, is determining when the corporation has entered the zone of insolvency. Case law on the topic shows the courts generally apply two tests—(1) has the corporation developed a deficiency of assets below liabilities such that there is no reasonable prospect that the business of the corporation can be successfully continued (the “balance sheet” test), or (2) has the corporation become unable to meet maturing obligations as they become due in the ordinary course of business (the “inability to pay debts” test). The standards vary from jurisdiction to jurisdiction with some states applying just one of the tests while others take into account both tests. In addition to these formalistic tests, other indicators that raise “red flags” that a corporation is in or near the zone of insolvency include repeated losses that are being funded with unsound financing techniques, excessive emphasis on short-term profits over positive cash flow, a steadily increasing extension of the time needed to satisfy accounts payable and reliance on irregular accounting practices. Moreover, even if a specific company appears to be healthy there should be a higher level of concern when there is a sudden and dramatic downturn in the prospects of the industry or sector in which the company is operating, particularly when deteriorating conditions are adversely impacting key business partners, competitors and sources of capital and credit. For example, if it appears that lenders will be tightening credit terms companies with credit facilities that are not coming up for renewal until 12 or 18 months down the road should nonetheless begin taking steps to preserve their asset values and identify alternative strategies for financing their operations in the event that conditions do not improve by the time their current facility expires.

Directors and executive officers, particularly directors and officers of the many publicly listed companies incorporated in Delaware, must be mindful of the expanded fiduciary duties that may be imposed on them in the event that the corporation enters what the

⁸ For a useful overview of corporate governance issues confronting troubled companies and the need for experienced guidance from counsel, see D. Baker, J. Butler Jr. and M. McDermott, “Corporate Governance of Troubled Companies and the Role of Restructuring Counsel”, *The Business Lawyer*, 63 (May 2008), 855-879.

Delaware Chancery Court has referred to as the “zone of insolvency.” Simply put, Delaware courts have made it clear that directors and officers operating a corporation that has drifted into the zone of insolvency owe fiduciary duties not only to the shareholders, as is the case with any corporation, but to creditors of the corporation also and this means that directors and officers must act in ways that preserve the value of the corporation’s assets for the benefit of the creditors so that creditor claims can be satisfied. The ability of directors and officers to effectively discharge their duties to creditors has been complicated by the turbulent conditions in the financial and credit markets. In the past creditors may have been willing to work patiently with troubled borrowers under a carefully crafted forbearance agreement that protected the creditors and outlined the steps that the borrower was expected to take to resolve operating issues; however, it is now much more likely that creditors push for more radical solutions including bankruptcy. One reason is that troubled borrowers no longer have other options to obtain financing that could be used to facilitate an exit from the credit arrangement by the original lenders.

When it becomes clear that the company cannot satisfy its current future obligations, each of the directors need to move quickly to consider and implement one of the insolvency procedures. It is essential for directors to request and obtain accurate and timely financial and operational information in order to make fully informed and justifiable decisions about the fate of the company. If formal bankruptcy procedures are required the directors will no longer be involved in the management of the business once a receiver or liquidator has been appointed; however, they must continue to cooperate by producing documents and supplying other required information. Among other things, directors should be sure that all of the company’s books and records of board proceedings are in order and advise should be obtained from qualified outside counsel regarding the record that should be created and maintained relating to the deliberations of the board as it deliberated on the decisions made during the crisis period.

It is also important for the directors and senior officers to understand when they become subject to demand standards that will apply when the corporation is in the zone of insolvency and to be mindful of the following basic guidelines for actions that should be avoided to reduce the likelihood of liability on claims of a breach of fiduciary duties to shareholders and/or creditors:

- Approving an operating and business plan that is not feasible and which is based on unrealistic assumptions regarding market and economic conditions and the availability of liquidity and capital resources. This would include specific strategic decisions such as undertaking an acquisition or any other form of business expansion project that must be financed by increasing debt to dangerous levels.
- Failing to conduct a rigorous review of potential cost-cutting measures and implement changes required to reduce negative cash flow during times of diminished sales activities. Managing expenses begins at the very top of the organizational structure and directors should avoid approving any compensation arrangement for senior executives that may, in hindsight, be viewed as “excessive.” Note that in the current regulatory and media environment, salaries and benefits that would have gone unnoticed in the past will now be closely scrutinized.

- Engaging in, or approving or otherwise condoning, insider transactions. Even if efforts are made to structure transactions between the corporation and directors and senior executives in a way that appears to be “arm’s length,” creditors will invariably raise concerns about conflicts of interest and any apparent advantage to an insider, even if unforeseen when the transaction occurred, will generally trigger a claim that a fiduciary duty to the creditors was breached.
- Leveraging unencumbered assets to raise cash in order to fill gaps in cash flows caused by a steep downturn in operating revenues. While some additional secured financing may be necessary in certain instances it is generally best to focus on cost-cutting measures particularly when the value of the encumbered assets is fluctuating in turbulent markets.
- Failing to consider alternative liquidity scenarios for the corporation as a whole or certain of its assets. While the directors and senior executives may be reluctant to sell the entire business or key divisions they should not ignore opportunities to attain value for shareholders and creditors. Division sales may be particularly appropriate when the directors and senior executives have decided to refocus on core businesses that do not include the particular division.
- Failing to take steps to try and avoid damaging defections by directors, senior executives and other key employees. As difficult as it may be, directors must avoid the temptation to resign as times get particularly tough since leaving the corporation without adequate oversight will only increase the likelihood that the former directors will be sued. Senior executives and key employees should be offered incentives to stay with the corporation and help get it through the storm; however, the incentives should be realistic and closely aligned to performance.

There are also several important affirmative actions that directors and senior officers should take when the corporation is in, or approaching, the zone of insolvency. One of the things that should be done immediately is a comprehensive review of the D&O insurance coverage available to the directors and officers. Directors should evaluate the financial strength of the carrier and renewal dates should be verified so that steps can be taken to keep the coverage in place without interruption. If possible, directors and officers should supplement their standard protections by obtaining "Side A-only" excess coverage that would be available to make payments directly to the directors and officers in situations where the corporation cannot, or is unwilling, to indemnify them. It is important for insurance to be in place before the corporation enters the zone of insolvency. Directors should also be made aware of limitations of exculpatory provisions in the company’s charter documents.

Making sure that corporate governance procedures are understood and followed is particularly important when the corporation is in the zone of insolvency. In addition, however, this is the time to make sure that directors and senior officers have access to timely, accurate and pragmatic advice from professional advisors with experience in working with troubled companies in workout situations. For example, as asset values fluctuate dramatically the company’s independent accountants must be able to advise how the company’s financial statements will be impacted. Restructuring professionals should be consulted to evaluate the company’s situation and provide various alternative

strategies for dealing with creditors including the possibility of seeking bankruptcy protection to provide a structured respite from day-to-day events that will allow the company to stabilize its business activities. These professionals, working with counsel, can also build communications with major creditors to assure them that management is acting prudently and seek their input before major decisions that might impact their rights are finalized and implemented.

References and Resources

The Sustainable Entrepreneurship Project's Library of Resources for Sustainable Entrepreneurs relating to Managing Growth and Change is available at <https://seproject.org/managing-growth-and-change/> and includes materials relating to the subject matters of this Guide including various Project publications such as handbooks, guides, briefings, articles, checklists, forms, forms, videos and audio works and other resources; management tools such as checklists and questionnaires, forms and training materials; books; chapters or articles in books; articles in journals, newspapers and magazines; theses and dissertations; papers; government and other public domain publications; online articles and databases; blogs; websites; and webinars and podcasts. Changes to the Library are made on a continuous basis and notifications of changes, as well as new versions of this Guide, will be provided to readers that enter their names on the Project mailing list by following the procedures on the Project's website.

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