

Managing Struggling Businesses

By Brian L. Davidoff

Astute directors, officers and business owners should be on the lookout for the warning signs of financial duress:

- A call from the bank alerting management that the financial ratios or loan covenants pursuant to its credit agreement are out of compliance. Shrewd owners are intimately aware of the status of accounts payable and accounts receivable, and how they are trending, so they likely would have pre-empted such a call to manage their banker's expectations.
- The filing of a lawsuit or a writ of attachment from a creditor or vendor. A writ of attachment is an application to the court to freeze assets pending the outcome of a trial, and it can significantly hamper operations of a business.
- Significant or sudden turnover of management staff. Managers typically are closest to day-to-day activ-

ities. If they experience stress or perceive that the business is not performing well, they may leave for greener pastures.

- Set-off or freezing of the business's bank account due to a loan delinquency. If the business has gotten to the point where the bank account has been frozen, this is a sure sign that management has waited too long and will have limited options. It's probably too late to move to a more flexible lender.

When a business becomes financially distressed, the owner often reacts by withholding information from the company's bank, creditors, and even the employees. However, the information inevitably does come out. Lenders typically lose confidence in their borrowers if they learn about disturbing business events from third parties. The way one communicates information to creditors is crucial. If vendors and creditors calls haven't been returned they assume the worst. Getting back to them with a response is important.

It is important to determine which employees and managers need to get the information. Enlisting employees to buy into the turnaround process is essential. Letting employees know that the turnaround program is underway may prevent employee attrition and fall-off in production.

Typically, when ownership is forthright in dealing with its lender regarding financial problems, the bank will work with the business to keep it operating. It is more likely to accommodate a business in a turnaround, whether to help the owner reorganize, sell or even find a new lender, if the borrower has been forthcoming in the initial disclosure of the issues and continues to be forthcoming as the turnaround proceeds.

DIRECTORS AND OFFICERS LIABILITY

The slide from a solvent business to the “zone of insolvency” has an important effect on the duties of the directors. The duty of loyalty requires directors and officers to perform their duties in good faith and in a manner that they reasonably believe to be in the best interests of the company. The duty of loyalty generally mandates that the best interests of the corporation and its shareholders take precedence over any interests possessed by a director, officer, or controlling shareholder, and not shared by the stockholders generally.

The duty of care requires directors and officers to act with the care an ordinarily prudent person in a like position would exercise under similar circumstances. A director or officer who fails to exercise appropriate diligence may violate the duty of care, even if such officer or director did not realize any personal gain from the transaction at issue.

However, directors and officers are generally protected by the “business judgment” rule from liability arising from negligent acts (as opposed to intentional or grossly negligent misconduct).

In general, directors and officers do not owe a fiduciary duty to creditors. However, if the company’s financial condition deteriorates to the point of insolvency or the “zone of insolvency,” a director’s fiduciary duties expand to include the protection of corporate creditors.

Courts have not clearly defined when a company is in the “zone of insolvency.” One typically applied measure is that a company is insolvent when its liabilities exceed its assets. A court may, however, find a business is in the zone of insolvency if the action in question by the directors would or reasonably could render the corporation insolvent, or if there is the risk that creditors will not be paid as a result of the directors’ action.

In short, outside of insolvency or the “zone of insolvency,” directors and officers owe a fiduciary duty to shareholders. Directors of an insolvent corporation have a fiduciary duty to creditors. It is unclear whether the duty to creditors supplants the directors’ duty to shareholders.

The duty to creditors has been described as the duty to protect their contractual and priority rights. Thus, liability may arise if the directors cause the business to incur unnecessary debt for the benefit of shareholder distributions, or otherwise divert assets from

legitimate business uses. Dividends awarded and paid when a company is insolvent can be claimed back under various theories.

THE LANGUAGE OF INSOLVENCY

Banks routinely move a defaulted loan from the regular loan officer to a “special assets” officer who is accustomed to working with turnaround consultants, and indeed in some cases will recommend a turnaround consultant to the business owner. One of the first things the consultant will do is assess inventory to determine whether it is overstated on the books.

This is a common problem with financially distressed companies, and one that management is not accustomed to reviewing. A consultant also will have experience in approaching a bank about a loan in default, with creditors clamoring for payment, and with employees who are nervous about losing their jobs.

An experienced turnaround consultant will also be valuable if the business ultimately has to file bankruptcy. The consultant can anticipate the procedural issues that arise in a bankruptcy, talk the language of insolvency with attorneys and creditors, and help prepare the necessary financial documents for a bankruptcy filing.

In summary:

- Be alert. Watch the financial metrics of the business so you do not find yourself on the eve of financial disaster without being aware of the direction the business is heading.
- Be proactive. Do not wait until the last minute before running out of cash or being shut out of the business premises. Statistically, companies that are proactive in addressing their financial problems have the greatest likelihood of surviving.
- Be forthcoming. It is critical that when the business is in financial distress, its owners are honest and forthcoming with the people who need to know about the situation and those who can help. This includes lenders, vendors, shareholders, some or all of the employees, and the team that was hired to help.
- Be savvy. Make sure you ask your attorney and turnaround advisor for all available alternatives.
- Be open. Too often, business owners cannot accept that their company is in financial distress. Be open to advice, including changing the way things have “always” been done.



Brian L. Davidoff, managing partner of Rutter Hobbs & Davidoff, specializes in corporate reorganization, restructuring and bankruptcy law. He advises companies on growth, financing, contractual relationships and operations, and he often serves as outside general counsel to his clients.
bdavidoff@rutterhobbs.com