Restructuring:

Top Ten Questions for Boards to Consider During a Down Cycle

Board Decision Making in a Down Cycle[1]

The last several months have been unprecedented in terms of how quickly and drastically business environments have changed. With widespread uncertainty and financial distress impacting so many businesses across industries, Boards of Directors are facing the challenge of a generation. To fulfill their duties to faithfully and carefully steer their companies through these tumultuous times (and to avoid liability to unhappy stakeholders in the process), directors need to intensify their focus. While there are no guarantees of success, boards that keep their heads out of the sand and follow best practices will maximize their companies' opportunities to weather the storm and emerge on the other side in an optimal position.

[1] The below focuses on directors of privately owned businesses. The additional reporting, compliance and other considerations for Boards of distressed publicly-traded companies are beyond the scope of this piece.

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Question 1

Are We Getting Real-Time Information from Management?

- To exercise their fiduciary duty of care, a Board must keep itself properly informed of the company's status. This is even more important when the company faces financial distress.
- Boards that fail to get accurate and timely financial reporting (both retrospective and prospective) from management risk second guessing in litigation by shareholders and creditors if things go poorly. The protections of the "business judgment rule" are powerful but rebuttable if plaintiffs can establish the Board was grossly negligent in keeping apprised of material information necessary to make decisions.
- At a minimum, the Board should require 13-week cash flow reporting from management, updated with frequency, as well as prompt alerts of any events that could have a material impact on the company's financial position (e.g., loan facility, lease or other key contract defaults, loss of key customers or employees, and government regulations that impact the business).

Question 2

Is the Board Meeting with Sufficient Frequency and Are Appropriate Minutes Being Kept?

- Times of distress by definition are not "business as usual." While micromanaging the officers operating the business with constant Board meetings is not required or helpful, Boards should amplify their focus when their businesses face turmoil. Boards should consider meeting weekly or biweekly (depending on the urgency) to receive updates and presentations from management and outside advisors, deliberate courses of action and vote on necessary steps to preserve and maximize the value of the business.
- Attention to proper corporate governance as well as diligent minute-keeping reflecting the frequency of meetings, the topics discussed and materials presented will be extremely valuable for directors in any subsequent fiduciary duty lawsuit.

Question 3

Does Management Have the Right Expertise to Deal with the Situation at Hand?

- Value of a business can only be maximized if the people actively running it have the tools and know-how to navigate the company through distress and communicate effectively with key stakeholders.
- Boards should test and question the information received from management and should view with skepticism rosy projections based on unrealistic assumptions.
- To the extent management is not equipped or is ignoring business realities, the Board should proactively replace weak links or appoint a new officer with the right experience and abilities to see the company through a period of distress and give accurate reports to the Board (e.g., a restructuring professional to serve temporarily as a chief restructuring officer).

Question 4

Does the Company Have the Right Outside Advisory Team under the Circumstances?

- Ignoring business realities and forging ahead into restructuring negotiations with creditors with a management team lacking in restructuring expertise is a recipe for disaster. To maximize optionality and, ultimately, value it is critical that experienced financial and legal restructuring professionals be brought in at the earliest feasible time to guide the process, negotiate with key stakeholders, effectuate transactions and advise the Board and management of the costs, benefits and risks of various courses of action. If the company and its Board delay in bringing in restructuring advisors until liquidity has nearly run out or the business is about to be foreclosed upon, the paths to resurgence or survival may already be gone even with the help of the most skilled restructuring professionals.

Question 5

What Is the Company's Liquidity Position?

- Boards must be laser-focused on how much cash runway is available to maintain operations. This includes conservative analyses of:
  - Future revenues, taking into account current economic realities;
  - Operating costs, as modified by any cash conservation measures; and
  - Availability under any credit facilities, taking into account any pending or anticipated defaults that could impair access to credit.
- The Board must be on top of management and understand what measures are being taken to maximize operational efficiencies and, if necessary, raise additional debt or equity financing to weather the storm.
- If the company has funded indebtedness or relies on a line of credit (as most do), the Board needs to know whether the company has or is in danger of breaching any covenants or otherwise defaulting under such facilities. If so, the Board needs to understand what management is doing to address the situation and ensure that the company is not cut off from critical liquidity or faced with an exercise of secured creditor remedies. A precipitous loss of liquidity due to a debt default can spell doom for a business and that will often lead to directors being embroiled in litigation by unpaid creditors and angry shareholders.

Question 6

Are Board Members Exposed to Personal Liability to Employees or Taxing Authorities?

- A paramount concern for the Board is whether the company's employees are at risk of not being paid for work they have done. Not only do companies have a moral obligation to ensure that employees are paid for their services, in certain circumstances the Fair Labor Standards Act as well as many states' wage and hour laws **impose personal liability on directors and officers for unpaid wages** (which may include accrued vacation and other benefits). Indeed some states attach criminal penalties for willful failures to pay employees.
- To avoid liability, directors need to be asking management:
  - How many payroll cycles the business can make (taking into account that many businesses pay employees in arrears so the wall may be closer then they may have thought)?
  - What the plan is to extend that period (e.g., capital raises, cost cuts, pay or hour reductions, furloughs and layoffs)?
  - If layoffs are being conducted, what process is being followed and how will the company be protected from claims of discrimination?
  - If the company needs to conduct a mass layoff or a plant closure, will the company be able to give legally required notice under the Worker Adjustment and Retraining Notification (WARN) Act and its state law counterparts?
  - What is the plan to shut down the business in an orderly fashion if the company runs out of funds to pay employees?
- All of these questions around employee liabilities are complex, nuanced and dependent on the jurisdiction in which the company operates. The Board needs to ensure the company has an experienced legal team to guide them.
- There is also the potential for personal director and officer liability for unpaid trust fund taxes (e.g., payroll, sales and excise taxes). If the business is withholding taxes from employees or collecting taxes from customers, the Board needs to ensure the business is carefully accounting for and remitting those funds to the taxing authorities.

Question 7

Should We Bring on a New Independent Director?

- When facing solvency concerns, the Board should consider bringing on one or more truly independent directors with experience in restructuring, distressed transactions and bankruptcy to guide the Board in key restructuring decisions and transactions. This will give comfort to creditors and other stakeholders whose cooperation and support is necessary under the circumstances that the Board is not being manipulated into breaching their duties to the enterprise by the self-interested parties who appointed them. It will also provide protection to the non-independent directors if their decisions are later challenged.

Question 8

Should We Form a Special Committee to Deal with Restructuring Issues?

- Related to the question of bringing on independent directors is the question of whether a special committee of independent directors should be formed to control restructuring negotiations free from the actual or perceived taint of the interested directors.
- As transactions between a company and its insiders are subject to enhanced legal scrutiny and burdens of proof, Boards should strongly consider appointing a special committee of independent directors with sole approval or veto rights in situations where the company is negotiating a restructuring transaction with insiders, especially if the transaction involves any settlements with or releases in favor of the insiders over prior conduct.
- If circumstances permit, the special committee should be authorized to hire its own independent outside legal and financial advisors to further insulate their decisions from those of the interested directors.

Question 9

Does the Company Have Adequate Insurance?

- This question needs to be top of mind as directors need comfort that the business will have protection from material insurable risks as well as personal coverage for the potential liability and certain costs of a breach of duty or similar suit in a downside scenario.
- In recent years, Directors & Officers (D&O) insurance has become increasingly costly and limited in its coverage, especially in insolvency situations. That trend has only accelerated since the onset of the COVID-19 pandemic.
- Boards need to expect that renewing or expanding insurance coverage when a company's financial position is weakening is going to be difficult and expensive. The company needs to work with an insurance broker with experience in insuring distressed businesses well in advance of a policy expiring. The more time the broker has to negotiate with insurers and work the marketplace, the better the outcome will be. Businesses that wait until the last minute to renew (which may have been the case in prior years with no harm caused) will now find that renewed coverage is either not available or painfully expensive.

Question 10

Should I Drop off the Board?

- In times of distress, directors may become concerned about the personal risk of remaining on the Board or may just not be willing to do the hard work needed to address the situation, especially if that director was appointed by a shareholder with little to no hope of a recovery. These concerns are amplified if the Board is dysfunctional or other members of the Board are making questionable decisions that the outvoted director has no power to stop.
- Directors are not required to remain on the Board against their will. An exiting director, however, should weigh the following considerations before dropping off the Board:
  - Am I better off being under the tent and receiving non-public information about the business?
  - Are the remaining directors equipped to steer the ship or will I be accused of having left the business rudderless?
  - Do I have concerns that the remaining board will make bad decisions that could create liability for me and my institution?
  - Am I protected by D&O insurance for decisions made under my watch?

Contact Us

We stand ready and able to help you think through these questions and position you for the best possible outcome.

Financial Restructuring

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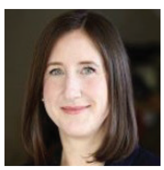

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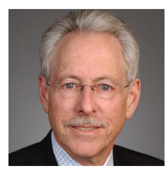

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