# Reshape Your Board For Company Restructuring

**by Pankaj Amin and Deborah A. Reperowitz**

**The ongoing economic convulsions of 2020 have brought unprecedented stress to many companies. Continuous pressure on revenues, production, sales and personnel are forcing boards and managers to weigh major, bet-the-company restructuring plans for survival. Is your board membership up to the task—and are they prepared for the dangers restructuring brings?**

This year the world turned on a dime. COVID-19 has presented worldwide healthcare challenges, resulting in skyrocketing unemployment to levels higher than any since the Great Depression. The pandemic's impact has been intensified by the fact that corporate balance sheets are heavily indebted after a decade of low interest rates.

Accordingly, corporate boards face the responsibility of overseeing businesses that have changed in record speed, with uncertainty regarding what the new normal will look like and when it will arrive. Moreover, the need to identify skills that will enable companies to properly navigate the current economic conditions, and thrive in a new economic environment is critical.

Inevitably, in the next 12 to 24 months, we will see a significant increase in distressed companies, bankruptcy filings, and financial, operational and organizational restructuring. Independent board members will be forced to understand and meticulously discharge shifting fiduciary obligations, while juggling hands-on oversight. They also will face the emotional toll on company management, financial, operational and strategic stress and critical decision making.

To properly discharge their obligations to their company in this time of restructuring, the case for bringing new independent directors onto a board is compelling. Following, we outline the need for new directors, as well as considerations that boards should examine in selecting new members.

New skills; relationships/experience in the restructuring industry; board fiduciary risk mitigation; and responsiveness are four major reasons for boards to consider augmenting their board composition in times of financial distress.

**As early in the restructuring process as possible, the board should identify litigation dangers. For example, if "corporate formalities" have not been observed, the corporate veil can be pierced.**

☐ ***New skill sets.*** The board of a company in financial distress faces different issues and must move with greater urgency than the board of a healthy company. Throughout the reorganization process, the board must understand the standards of insolvency and their implications for the company, its creditors and its equity holders.

As soon as the board becomes aware that the company may need to restructure, it must develop a deep understanding of the company's business and finances. It should monitor cash flow on a daily basis, and needs to move swiftly to begin assessing alternatives to recovery. If there is an insufficient number of independent or "outside" board members, or the existing board members are not up to these tasks, new, independent directors who can undertake these responsibilities should be added.

As early in the restructuring process as possible, the board should identify legal and factual issues that may become the subject of inquiry by parties-in-interest. These include mass or class litigation against the company, questions of financial, operational

**Pankaj Amin** *is managing director of SC Ventures.* **Deborah A. Reperowitz** *is co-chair of the bankruptcy group for Stradley Ronon Stevens & Young, LLP.*

or other mismanagement, composition and pay of management and board members, and the company's relationship with its affiliates. What if "corporate formalities" have not been observed, allowing the corporate veil to be pierced?

If such issues are identified early in the turnaround process, consider adding independent board members with expertise in these areas to the board, so that it is prepared to address these matters.

As an example, in the 1990s, Al Dunlap was retained by Scott Paper Company as chairman and CEO to turn around the then 115-year-old paper products company. The company had conducted a number of layoffs, as well as taken restructuring charges due to declining profitability and marketplace position.

**In restructuring, the board may not be able to rely upon, or collaborate with, company management as they had done when the company was healthy.**

One of the many actions taken during the turnaround process was to analyze the board directors to ensure that they were tailored to affect the changes necessary for the company's survival. Of concern was the fact that several legacy directors were connected by family lineage over a century, and may not be up to the turnaround task. Ultimately, Scott Paper changed its board compensation to align with performance and brought on new directors to align with the restructured culture.

☐ ***Relationships and experience in restructuring.*** Boards are required to make critical decisions on an urgent basis when their company is in turnaround mode. They may not be able to rely upon, or collaborate with, company management as they had done when the company was healthy.

It is not uncommon in a distressed situation for a company's management team to be stretched operationally, fear job insecurity and focus on justifying their prior decisions or actions, rather than working with the board on reorganization action plans. Moreover, the board may have lost confidence in its management team if the board believes that actions, inaction and recommendations of management caused or contributed to the company's distress.

Given this, it is important that the board have members with restructuring experience and general knowledge of the company's industry. While outside professionals may be retained to assist the board with almost any issue, overuse of external professionals is an extremely costly approach, and the interests of these counselors are not always aligned with the interests of the company or the board.

Directors with turnaround expertise will be familiar with the restructuring playbook and can help the board lead, rather than follow, on turnaround issues. Moreover, such board members will have well-established relationships with trustworthy restructuring advisors, capital sources and industry experts that they can call upon to obtain insights, information and recommendations.

Finally, these board members will result in cost savings for the company. They can guide the board on many issues that a board with no restructuring experience would need to take to outside professionals. Unlike outside advisors, the interests and goals of these board members will be wholly aligned with those of existing directors. Adding board members with restructuring expertise can be critical to a successful outcome for the company (and the defense of potential claims against the board).

When WorldCom filed for bankruptcy protection in 2002, it was the largest filing to date, with more than $100 billion in assets. The company was founded as an alternative telecommunications carrier, and completed a number of acquisitions, including MCI, in order to position itself as a major carrier. However, its high fixed cost structure, as well as its variable revenue base created a situation where accounting fraud by certain executives was suspected when the company was unable to service its debt.

As a result, the board brought on three new directors with accounting and legal expertise to lead the board's newly-formed committee focused on investigating management. These directors also brought relationships within the restructuring industry in order to quickly execute what ultimately was an extremely complicated fraud investigation into the company's

## A Restructuring Board

### Successful Turnarounds Require A Cross-Functional Approach

| | Strategy | Tactical Execution |
|---|---|---|
| **Finance** | • Identifying alternative financing<br>• Assessing cost structure and profitability in a restructured environment<br>• Developing a deep understanding of company's financing and financial systems | • Setting culture of communication with key stakeholders<br>• Tracking status and progress of cash flow daily<br>• Evaluating all levels of organization to drive cash flow<br>• Modifying financial systems if required |
| **Operations** | • Understanding market dynamics<br>• Developing a deep understanding of company's operations and leadership<br>• Aligning production to meet changes in demand<br>• Investing in innovation to expand market share | • Maintaining customer and supplier relationships<br>• Taking decision action toward sustainable market and product position<br>• Changing culture for new company needs |
| **Law** | • Understanding pros and cons of legal options pre-restructuring, including a possible bankruptcy filing<br>• Maximizing value for stakeholders | • Ongoing tracking of litigation, compliance and regulatory requirements<br>• Communicating legal needs as they drive operational decisions throughout organization<br>• Retaining outside counsel |

| Contextual Factors |
|---|
| • Understanding market dynamics and competitor financial position<br>• Tracking macroeconomic factors, monetary policy decisions, and politics<br>• Monitoring access to capital from all types of capital sources<br>• Understanding mergers and acquisition environment<br>• Benchmarking best practices in the industry |

accounting practices. The newly-formed committee and the new directors allowed the board to play a significant role in the fraud investigation.

☐ ***Mitigating fiduciary risk.*** When a company is in financial distress, fiduciary obligations may shift and be scrutinized, particularly if the company becomes insolvent and/or lands in bankruptcy. As part of its fiduciary obligation, the board must uphold a duty of care that requires a near-constant evaluation of strategic options to ensure the company, its shareholders and its creditors receive maximum benefit.

The need for independent board members who avoid conflicts of interest is critical at such times. As companies face operational or financial struggles or a potential bankruptcy filing, there often is a need to form one or more special committees, such as a financial oversight committee, an investigative committee, a transactional committee or a special litigation committee.

Moreover, the need to strengthen existing committees, particularly audit and compensation, may be warranted. These committees must demonstrate

their independence and show that their actions are free from conflicts of interest that may exist among current board directors. Therefore, new independent directors may be critical to providing a line of defense for the board and the company in the event of future challenges.

When Edison Mission, a California-based energy holding company filed for Chapter 11 protection, the company added independent directors for situations where conflicts could exist. These directors were members of the company's compensation committee, and their decisions on incentive and retention distribution were approved by the U.S. Bankruptcy Court in Chicago, despite objections by the U.S. trustee. Ultimately, the role of a new independent director can augment impartiality in board actions and decision making.

A board of directors also must be acutely aware of "red flags" that signify financial distress and scream out for board action. The fall of Enron Corporation is one of the most highly-publicized cases on this point. Enron and a number of its subsidiaries filed for Chapter 11 bankruptcy protection on December 2, 2001. At that time, Enron was the seventh largest publicly traded corporation in the United States. Innumerable questions arose concerning the propriety of the actions and inactions of Enron's board, and an in-depth investigation was undertaken by a United States Senate subcommittee.

The subcommittee took extensive discovery from present and former board members, held a hearing, and generated a report of its findings. The subcommittee noted that typical board of director duties include reviewing the company's overall business strategy, selecting and compensating the company's senior executives, evaluating the company's outside auditor, overseeing the company's financial statements, and monitoring overall company performance.

The subcommittee found that the Enron's board had failed to properly discharge its fiduciary duties to act in good faith, with reasonable care. Specifically, it found that Enron's board had ignored high-risk accounting practices and allowed inappropriate conflicts of interest to exist. The board also allowed off-the-books activity that misrepresented the companies' financial condition, a lack of independence for Enron's board and auditors, excessive compensation, and inadequate disclosures. Although Enron's board's misdeeds were extreme, the investigation by the subcommittee serves as an example of what can occur when a board fails to meet its obligations.

**As a company's financial condition deteriorates, its board must confront difficult decisions on management, operations, finances, advisors, board composition and prior board actions.**

☐ ***Urgency and the need for responsiveness.*** Companies facing distress and economic uncertainty require board members who are available to meet or discuss critical, time-sensitive issues on a moment's notice. As a company's financial condition deteriorates, its board must confront difficult decisions, often on an emergent basis, including those regarding management, operations, finances, retention of professionals, board composition and prior board actions and practices.

Existing board members may not be up to this task, and some board members may resign given these increased demands. For example, in the seven weeks prior to Hertz filing for bankruptcy earlier this year, its board met at least ten times, and likely had to consider issues and make decisions outside of its comfort zone. The critical, unique decisions facing a board when the company is in financial distress require members to have time, an emotionally grounded foundation, and the ability to respond to numerous fires simultaneously.

Bringing new board members to the table, and forming new oversight committees dominated by these directors, can be pivotal in driving a successful turnaround. Failure to address these issues early in the restructuring process could result in the company being forced by its equity holders, a court or creditors' committee to add board members that are not of its choosing.

Since every restructuring situation is unique, a cookie cutter approach to selecting new directors

will not deliver optimal results. What should a board consider in bringing on new members during a time of financial distress? An owner-oriented mindset, frugality, optimism, and commitment are some of the key qualities that must be considered in augmenting the company's board.

We believe that four non-exclusive core qualities should be used to evaluate an independent director when the company is in restructure mode: character, creativity, capabilities and experience.

☐ ***Character.*** As with any independent director, additions to the board of a distressed company must have a foundation in ethics, financial clarity, and emotional stability in crisis. There is a potential shifting of board fiduciary obligations. The company, its management and the board may be under scrutiny, particularly if the company becomes a debtor in bankruptcy.

Thus, understanding the legal, moral and ethical obligations of the board and discharging these obligations impeccably is absolutely imperative. In a restructure, a company's board must have the trust and respect of parties-in-interest, and potentially a court, so that critical support for the company's turnaround plan can be secured.

☐ ***Creativity.*** Creativity, tempered by practicality, is essential to a successful restructure. Every company is different, from the nature of the business, to the capabilities of its management, the cause of its distress, the structure of its financing and the impact of external events.

It is here where business acumen, entrepreneurial spirit, and prudent risk-taking combine to achieve positive results. An independent board member must understand the company's situation, critically analyze recovery options and creatively think "outside the box." Develop a turnaround plan that has a reasonable prospect of success, together with contingency plans in case the company has to jump to an alternative.

☐ ***Capabilities.*** Knowledge of the industry at legal, operational, and financial levels is intrinsic to addressing restructuring needs expeditiously and effectively. In addition, board members of a troubled company must possess the drive, tenacity, determination and commitment to push the company through an often difficult and complicated process. It inevitably will hit roadblocks, disputes and challenges along the way.

One capability to consider when selecting new board members in a time of financial distress is the ability to communicate and testify in a deposition or before a court. In bankruptcy, an officer generally becomes the representative of the company, testifying as needed. Occasionally, a board member must also testify, particularly if creditors or other parties-in-interest undertake an investigation of the board and its activities. The board should designate one of its members to be a witness, if necessary, and make sure that designee is a thoughtful, credible and persuasive communicator and active board member.

☐ ***Experience.*** The board of a distressed company should consider adding members with experience in the restructuring industry and other matters that may arise during the company's restructure. Waiting too long before adding such board members can raise questions on whether the board properly discharged its fiduciary responsibilities, and could result in new members being forced upon the board by third parties or the court.

When a healthy company begins to slip into financial distress, its board must spring into action. Cash flow must be scrutinized daily, operations and management must be examined, and lines of communication between the company's finance and operations teams must be ongoing. The cause of distress needs to be understood, the board's fiduciary obligations need to be known, operational and financial restructuring options must be identified and analyzed, and professionals must be retained.

Before the board attempts to tackle the foregoing, it should add one or more independent members to its board. At least one needs extensive turnaround experience and others, as circumstances dictate, should have financial, operational or other subject matter expertise. ■

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