



CFO

WORLD TURNED UPSIDE DOWN

**IN THE
“INSOLVENCY
ZONE,”
CREDITORS
EXERT A STRONG
PULL THAT
OFTEN THROWS
CFOs OFF
BALANCE.**

BY VINCENT RYAN

THE ECONOMY has weakened most companies, but it has strengthened the hand of one group: creditors. Marginalized somewhat the past few years, banks are once again imposing stiff covenants and pricing risk profitably. Bondholders, determined not to bear the brunt of restructurings, are beating back offers to exchange their notes at a discount. Commercial lenders are extracting highly prized collateral from companies needing working capital. ¶ In short, creditors have their groove back. They're peering over the shoulders of CFOs to make sure that company assets, many of which are at risk, are preserved. With good reason: Moody's Investors Service projects ►

that the recovery rate for senior unsecured bonds will average 33% in 2009, the lowest rate since 2002 (see “Slim Pickings,” this page). “If there are fewer funds to pay out to creditors, they always look for ways to increase their recovery,” says Sam Alberts, a partner in restructuring at law firm White & Case.

The revival of the creditor class presents a major challenge for CFOs of financially stressed companies—particularly those approaching the “zone of insolvency,” a legal term for when a company is in imminent danger of going bankrupt. Since 1991, the Delaware courts have found that when companies are in the zone of insolvency, management and boards are not just the agents of shareholders. They have a fiduciary obligation to a wider community of interests, particularly creditors. Delaware case law has evolved over the past two years to shelter directors and officers from direct creditor claims (see “Could This Get Personal?” facing page), but the zone-of-insolvency issue is far from resolved.

“It has always been the case that directors owe their duties to the corporation and that the residual owners of the corporation [creditors] have the ability to en-

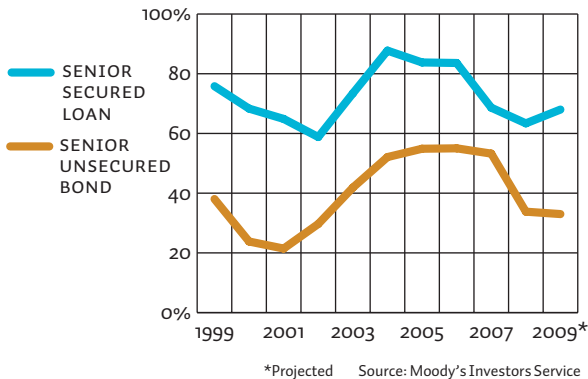


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— WILLIAM LENHART, NATIONAL DIRECTOR OF RESTRUCTURING AT BDO CONSULTING

SLIM PICKINGS | THE RECOVERY RATES OF DEBTHOLDERS SLIP

Average bond and loan recovery rates, U.S. issuers



force the performance of those duties,” says Corinne Ball, a partner at law firm Jones Day.

But when, exactly, does a company enter the zone of insolvency and trigger that new obligation? The law offers no bright-line test. And how do you run a company for the simultaneous benefit of shareholders and creditors? Their demands can be vastly different. Shareholders have a strong incentive to avoid bankruptcy, even if that means dissipating the firm’s assets with last-ditch strategies. But creditors want to preserve capital, so a sale of those assets—or even the company’s liquidation—may be their preference. To whom do CFOs owe their fiduciary duty, and to what degree?

One thing is clear: the finance chief is the company’s point person in navigating this poorly defined terrain. “It’s incumbent upon the CFO to bring this to the attention

of the president and the board on a timely basis,” says Charles Kuoni of turnaround firm CRG Partners.

WHERE IS THE ZONE?

IDENTIFYING THE ZONE OF INSOLVENCY IS ANYTHING but simple. “You never know for sure if you are operating in it,” says Richard Lindenmuth, managing director of Boulder International LLC, a management consultancy. “You’re not stepping across a well-defined border.”

Delaware law sets out two tests for determining insolvency. In the balance-sheet test, a company is insolvent if liabilities exceed assets, with no reasonable prospect that the business can be continued. The cash-flow test says a company is insolvent if it is unable to meet maturing obligations as they fall due in the ordinary course of business. Neither standard is definitive. General Motors’s liabilities have exceeded its assets by tens of billions of dollars for more than five reporting periods: Does that mean the company is in the zone of insolvency? Insolvency is often clear only in the rear-view mirror.

“[Asset] valuations right now are so ridiculous, you could venture to say many companies are in the zone of insolvency and they don’t even know it,” says William Lenhart, national director of restructuring at BDO Consulting. If a company is in the middle of a quarter and asset values are fluctuating wildly, the fair value of its assets and liabilities would be hard to pin down. Certain items, such as intangible assets, could be worth nothing if a company is liquidated. Other assets might be too illiquid for a company to pay its bills.

And how far behind on its debt payments does a company have to be to be considered insolvent? The prospect of recovery is one way to frame the question. “Are there reasonable expectations that the shareholder is money-good?” asks Jim Fogarty, a managing director at Alvarez & Marsal. “If a reasonable read on the future shows positive value for shareholders—and liquidity—the CFO still needs to be concerned about them. If not, he has to start thinking about creditors.”

The due diligence for an insolvency test is similar to what auditors perform for a going-concern opinion. Recurring operating losses, negative cash flow, adverse key financial ratios, payables growing in number and aging, denial of trade credit—all are negative indicators. But a qualification on a going-concern opinion doesn’t equal insolvency; a company that earns a qualification could be solvent for months. (Studies show that only half of firms that go bankrupt earn going-concern opinions prior to bankruptcy.)

What’s more, a company’s P&L might belie the fact that the business is on the runway to bankruptcy.

COULD THIS GET PERSONAL?

CAN CREDITORS SUE directors and officers for breach of fiduciary duty in the zone of insolvency? The answer, usually, is no—not directly, that is. When a company is actually insolvent, though, a creditor can pursue a “derivative claim” for breach of fiduciary duty—a suit on behalf of the company claiming fraud, mismanagement, or some kind of self-dealing.

Under the business-judgment rule, directors and officers can’t be held liable as long as they made decisions in good faith and in the best interests of the company. But it’s not bulletproof. Most CFOs need to review insurance policies and corporate charters to ensure that other defenses are in place.

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Directors’-and-officers’ (D&O) insurance provides some cover. But in a 2007 survey by Towers & Perrin, only 37% of companies reported purchasing

coverage for fiduciary liability, even though that was the second-most common D&O claim. The reason: the coverage was too expensive.

Yet, officers should insist on fiduciary coverage—and insist it be large enough, experts say. Defending shareholder and creditor lawsuits is costlier than many other kinds of litigation. Attorney James W. Parkman III recommends that CFOs consider buying their own insurance. If a company files for bankruptcy, the trustee could deem the D&O policy an asset of the corporation and freeze any payments for attorney’s fees, Parkman says.

Many companies indemnify directors and officers in charters and bylaws, which can limit their liability for breaches of the duty of care. “Indemnification basically protects them from the assertion that they acted negligently,” says attorney Sam Alberts of White & Case.

Such agreements need to be penned before a company draws near the zone of insolvency. Last February, Freescale Semiconductor signed an indemnification agreement with directors and certain officers (including the CFO) because of “the increased risk of litigation” and the need to retain executive talent. But the timing of the agreement drew attention. The company had reported a 2008 fourth-quarter loss of \$4.2 billion. It had also offered to exchange \$2.8 billion in bonds for \$1 billion in term loans, a transaction that “reduced the possible recovery rate of existing notes,” according to CreditSights. Senior lenders subsequently sued Freescale. —V.R.

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—JACEN DINOFF, CEO OF KCP ADVISORY GROUP

When Lindenmuth was hired by Amcast Industrial Corp., a manufacturer of aluminum wheels for cars, after the company emerged from Chapter 11, the near-term financials looked stable. But the auto industry grants parts contracts two years in advance, and during Amcast’s period of distress, carmakers hadn’t awarded it parts contracts for their new models. So the order pipeline was set to evaporate in a year’s time. “[Were we] right then in the zone of insolvency?” asks Lindenmuth. “Sometimes you can look far ahead [to bankruptcy], other times it’s sudden.” Amcast eventually liquidated.

DEALING WITH DENIAL

ONCE MANAGEMENT DETERMINES INSOLVENCY TO BE an issue, it should test for it regularly, says BDO’s Lenhart. But it isn’t just the numbers that trigger the expansion of fiduciary duties. If a company hires a workout firm, an investment banker, or an attorney because of its lack of liquidity, “it needs to be prudent about its practices from that point,” says Sheila Smith, a principal at Deloitte Financial Advisory Services.

Rallying management around this necessity is not easy. CEOs and even boards dwell in denial, and many third parties have an interest in keeping a company operating as long as possible. Otto Kubik, who provides CFO support services, has never had to raise the specter of insolvency to a CEO. “But I have had to present bad news of far lesser impact,” he says. “Uniformly, this was greeted with negative, dismissive, and sometimes personally hostile reactions.”

Last year, Kubik was offered a job at a \$200 million (in revenues), privately held recreational vehicle manufacturer. The CPA firm interviewing Kubik told him the company had a robust line of credit and just needed timelier financial reporting and tightened internal controls. At the other end of the building, though, a bank’s workout team was poring over the books. After receiving a copy of the financials, Kubik discovered that the company “had died quite some time ago.”

It’s not the CFO’s role to declare that a company is in the zone of insolvency, but rather to report that financial risks are elevated. “The board members have to be ad-

vised,” Lindenmuth says. “But you’re not a legal person. You present the financial statements, the obligations, the cash flow; you point out the substantial risk of busting covenants on loan agreements and delaying payments to vendors. You present the side of the story that is worst-case.”

The attorneys have the job of informing the board that the company is in the zone and that decision-making therefore requires a new filter—the interests of creditors as well as shareholders. CFOs must incorporate the filter into all decisions going forward.

STAYING SHORT

FORTUNATELY, MUCH OF WHAT’S LEGALLY PRUDENT fits with what is financially so. Since part of the battle now is to preserve assets, it’s time to shorten up, say experts. Purchase inventory and pay bills in smaller increments, for example, and don’t make long-term buying commitments. Pull back capital investments, too.

“Changing the culture of a troubled business is a challenge,” says Doug Laux, CFO of \$1.2 billion auto-parts supplier Remy International. Remy filed for Chapter 11 in 2007 and closed 14 facilities worldwide, ripping costs out of the business. “If you don’t know you can make payroll in three months, you have to pull the horizon shorter,” says Laux, who has been at the helm of other turnarounds besides Remy.

Conserving cash doesn’t rule out new borrowing. For example, Deloitte’s Smith ran a building-materials business that was highly seasonal. Lead times for purchasing inventory were long. When the company faltered, she was required to post standby letters of credit to get suppliers to ship lumber, which further dried up liquidity. “We had to borrow money to buy inventory to create sales,” says Smith. “That was OK, because buying lumber was a critical commodity for harnessing the business and driving sales.”

In the past two years, the Delaware courts have ruled that management can increase leverage when a company is insolvent, modifying decisions judges made earlier in this decade. Those decisions held that officers could be sued for “deepening insolvency”—the “fraudulent expansion of corporate debt and [the] prolongation of corporate life.” Now, however, the fact that management drove a firm deeper in the red by borrowing is not a valid cause of action for creditors.

Whether creditors will allow a company to continue borrowing when it is already bleeding capital is another matter. Banks are clamping down on the growth plans of cash-strapped firms, especially if covenant violations loom. Casino operator MGM Mirage got a reprieve from its banks last March, but it came with a \$300 million cut in borrowing capacity, a prohibition against incurring a

material amount of debt, and a dollar limit on new investments in CityCenter, MGM's unfinished luxury residential complex in Las Vegas.

When confronted with major decisions on assets—the sale of a division, for example—management of a near-insolvent company needs solvency and fairness opinions from a third party, says Tim Cummins, a managing director at Stout Risius Ross. Creditors could accuse management of not obtaining a market-clearing price, and an opinion provides some defense. In a bankruptcy court, a below-market price could translate into a fraudulent conveyance—a transfer done with the intent of moving the asset outside creditors' reach.

DELICATE DECISIONS

ONCE FIRMLY IN THE ZONE OF INSOLVENCY, FINANCE officers should be open and up-front with creditors to best maintain the relationship, says Jacen Dinoff, CEO of KCP Advisory Group. Dinoff has two rules for dealing with creditors: one, don't promise that you're going to pay them when your cash flow will not provide for payment; two, don't tell them your business won't file for bankruptcy. "You can say, 'Our intention is not to file,'" says Dinoff. "But you're going to need credibility in your dealings." If executives misrepresent the reality of the business's position, they may pay for it later in a forum like bankruptcy court, he says. "You may find key creditors whose losses have financed the bankruptcy demonstrating to the court that 'these guys can't run the

business, they never meet the plan.'"

Adhering to a deliberate and meticulously documented decision-making process puts management on stronger footing. The documentation should include board minutes, as well as a record of what information and analysis were examined to arrive at a decision, says Alberts of White & Case. The documentation advice goes double for any transaction that affects an insider—bonuses, dividends, loans, asset sales. "Plaintiffs see that as fair game," says Alberts.

Overprotecting against future second-guessing by plaintiffs has a drawback: it slows decision-making dramatically. Ironically, creditor lawsuits often arise when a CFO acts with too much deliberation—delaying a layoff, for example, when cash levels demand it be done immediately. The answer is to lay an adequate paper trail, not the longest one possible. As long as a decision is examined from both the equity holders' and the creditors' perspectives, CFOs need not be fearful, says Lindenmuth.

Even so, the zone of insolvency is a realm into which CFOs would rather not venture. But they can't ignore it. A management team that is monitoring insolvency measures and keeping creditors' interests in mind gives itself more options in a restructuring. And it grasps problems earlier. Says BDO's Lenhart: "Managements that don't acknowledge cash-flow problems and plow ahead as if it were the status quo, those are the ones that are walking into trouble—and getting sued." **CFO**

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