Behavioral Assessment: A New Approach to Evaluating a Company in Crisis

By Bob Cohen, Centrus Group

There are numerous methods with which a financially challenged company can assess the magnitude of the difficulties facing the organization. This article will address an evaluation method that provides a rapid and clear understanding of the key issues and a timetable to determine the approximate time the company has to implement correction action before failure. Focusing upon the behavior of company management is often the key to assessing its financial condition - specifically COMMUNICATION FAILURE, DENIAL and BLAME.

Traditionally, an evaluation of a company approaching financial crisis is determined by the background of the individual making the assessment. The company management, legal counsel, accountant, bank, vendors and the Certified Turnaround Professional (CTP) each view the subject company through their own perception of financial instability.

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President’s Report

by John K. Lane

Dear Ohio TMA Members and Friends,

I was having breakfast earlier this week with Dan DeMarco of Hahn Loeser and we were talking about some of the more difficult cases we had experienced in recent years. It was very clear that for the cases in which one or more of the involved parties got personal, the chances for a successful turnaround became nearly impossible. Please note, getting personal is an equal opportunity action in that it can be exhibited by bankers, attorneys, owners or even, god forbid, financial advisors!

Now, I am not talking about serving an ardent advocacy role for your client or your bank. That is something that is professionally required in all cases. I am talking about the “don’t confuse me with the facts and, by the way, I hate your guts” approach to a case. It always amazes me when a creditor looks at a moderately simple presentation of the likely impact of cooperation and then decides to take a substantially lower payout solely to “get back” at the debtor. To be fair, it is just as amazing when you present a debtor with the path to escape their issues through cooperation with the creditors and the debtor decides instead to pursue the same misguided adversarial path that got them in trouble in the first place.

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The Centrus Group is recognized as one of the premier turnaround practices in northern Ohio. It provides expert management and strategic services in the areas of turnarounds, crisis intervention, wind-down management, financial/debt restructuring, executive recruiting and divestitures. Based in Akron, Ohio, Centrus provides services throughout the United States and Canada.
President’s Report (continued)

Keeping things from “getting personal” is one of the main reasons for the existence of the Turnaround Management Association. We believe that getting to know other turnaround professionals through TMA activities helps promote a level of understanding and trust that will hopefully prevent a future case from getting personal. As an example, a few years back I was involved in a case in which all of the attorneys, the workout officer, and the financial advisors were very active in TMA and, for the most part, were on the TMA board. Simply put, there was not a lot of posturing and trying to understand the motivation of the other parties. We just got down to business and put together a successful turnaround.

Let us talk now about Ohio TMA chapter events.

I hope you had the benefit of attending our January session, “Putting the Bloom Back on the Rose, The Story Behind the Flower Factory Bankruptcy.” The great panel of Marc Merklin of Brouse McDowell, Chris Welsh of ARG Restructuring, Jean Robertson of Calfee Halter Griswold and Dave Wehrle of BBP Partners shared with us how they collectively achieved one of the few successful reorganizations over the past year. Certainly, it sounded like there were some difficult negotiations before arriving at the resolution, but because there was a high level of communication, a willingness to work together, and a recognition of challenges in the case, they were able to get the job done.

Next up on Friday, February 24, Larry Hill from Bernstein Global Wealth Management will be sharing with us his views on the current state of the economy and the economic outlook for 2012. Larry will help us make sense of how the fiscal challenges in the U.S. and Europe, as well as the sweeping changes in the Middle East, impacted the markets this past year. He correctly predicted a market expansion in 2011 and is foreseeing more of the same in 2012. Please join us at this event to hear more. Registration for this event will start at 11:30 a.m.; the lunch will start at noon, with Larry’s presentation following. This event will be held downtown at the Marriott at Key Center.

On the evening of Thursday, March 29, Ray Warner, Associate Dean and Professor of Law at St. John’s University; the Honorable Russ Kendig, Canton Division of the Northern District of Ohio Bankruptcy Court; and Harry Greenfield, attorney at Buckley King and Professor of Law at Cleveland-Marshall College of Law, will be discussing credit bidding cases, venue shopping, the latest on Stern v. Marshall and other recent court cases involving important bankruptcy issues. This evening event will be held at the Wyndham Hotel.

As always, you can sign up for all of the TMA events at www.turnaround.org. I hope that we will see you there!

Best regards,
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Legal counsel typically is most concerned that the company is meeting its contractual obligations. Compliance with bank covenants and financial ratios is of primary concern to legal counsel, which often measures the financial health of its client based on the timeliness of the payment of legal fees. While these benchmark measurements may all indicate a company in crisis, the problem with this approach is that each of these points of reference are symptoms of the problem and not the root cause of the crisis. The typical legal assessment is an “after the fact” approach to crisis management. The legal assessment often is employed much later in the process of implementing an effective turnaround strategy.

The company accountant reviews historical financial performance of the company, and much like the attorney, observes variances from planned performance after the deviation from plan has already occurred. The observed deviations from plan are an indication of the result of a problem. While the accountant is likely to observe the deviation from plan much earlier than legal counsel, it is still an after-the-fact observation.

The secured lender/banker typically takes action at a point in time far later than any of the other professionals who are external to the company. The bank relationship manager works as a sales person for the bank. Typically, the relationship manager infuses himself/herself into the company so deeply that it is difficult for the banker to have an objective view of the company. Often, the relationship manager is replaced with a bank representative from “Special Assets” or “Workout,” long after unfavorable deviations from covenants and formula have occurred. The secured lenders’ active participation with a company in crisis occurs very late in the crisis development stage.

Vendors of a company in crisis will observe its financial difficulties relatively early in the deterioration process. Often, actual payments that once were paid at 30 days become stretched to 60 days, then to 90 days and beyond. The problem for vendors in many cases is that they can have very little impact upon the company in crisis. If the vendor refuses to ship or provide services due to late payments, the company in crisis may merely change vendors and subsequently never pay the vendor.

The Certified Turnaround Profession will initially look to three issues. First, is there a core business? Second, is there adequate management in place to effectuate a turnaround? Third, are there adequate financial resources available to fund the turnaround process? Unfortunately, the turnaround professional is engaged by the company so late in the deterioration process that an effective turnaround is most difficult to successfully implement. The turnaround professional is typically engaged after the secured lender, the accountant and the attorney for the company all have agreed that the company is in crisis—very late in the process, thereby limiting the options available to the turnaround professional to effectuate a successful turnaround.

The most effective method to quickly assess the status of a company is to observe the behavior of company management. Applying a rather simple formula for all professionals as well as company management will serve as an effective benchmark to determine status of a company in crisis. Again, the key elements are COMMUNICATION FAILURE, DENIAL and BLAME.

COMMUNICATION FAILURE - Ineffective communication is the first step in the downward spiral. It can be defined as either ineffective speaking or ineffective listening on the part of company management as it relates to employees. Once ineffective communication exists within a company, without some other intervening correction, the company will likely fail within two years.

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Example: A Chief Financial Officer of a $50-million manufacturing company asked a turnaround professional what was the most obvious indication of a failing company. The turnaround professional stated that ineffective communications was the key element. The CFO noted that he did not have that problem at his company. He noted that the problem at his company is that the employees did not take the initiative to do the right thing. The turnaround professional responded by asking, “did management ever tell the employees that it was OK to take the initiative?”

DENIAL—Management of a failing company have a tendency to see their business through rose-colored glasses, even as the company progresses to the second step in the downward spiral. Management typically has experienced both good times and bad times in their careers and in most cases, successfully navigated companies through crisis situations. Unfortunately, management most often believes that they are capable of overcoming all challenges and obstacles by following the courses of action that they have taken in the past. Management is often convinced that under their leadership, the problem is not insurmountable and that they will overcome the challenges facing the company. Once the management team is in denial with regards to the status of the company, the company will likely fail within six months.

Example: “This is just a bump in the road.” “We have been here before and have done just fine.” “You are overstating the problem.” “Don’t worry.”

BLAME—Management now realizes that the company is failing as it proceeds to the third and final step of the downward spiral. Typically, management will seldom accept personal responsibility of the failing company, and reaches out to find blame to preserve their emotional and professional stature. Once management establishes that the failing company is the cause of someone other than themselves, the company will likely fail within 30 to 60 days.

Example: “It’s the bank’s fault because they wouldn’t lend us any more money.” “The CFO stole the money.” “The computer provided us inaccurate information.” “The Sales Manager stopped selling.”

The earlier in the process that action is taken, the greater is the likelihood of a successful outcome for everyone. All parties involved with the company, including management, legal counsel, accountants, vendors and the bank/secured lender must take a step back from traditional analysis from time to time and observe management’s behavior to understand the depth of the problem and how soon failure will occur, based upon this simple assessment.

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2012 Meeting Schedule*

Friday, February 24
Luncheon, Cleveland Marriott Downtown at Key Center – "The Current Economic Outlook and Beyond." Larry Hill from Bernstein Global Wealth Management will speak about the current state of the economy and the economic outlook for 2012.

Thursday, March 29
Evening, Wyndham Hotel – "Recent Court Decisions Affecting Bankruptcies." Ray Warner, Associate Dean and Professor of Law at St John's University, the Honorable Russ Kendig, Canton Division of the Northern District of Ohio Bankruptcy Court and Harry Greenfield, attorney with Buckley King and a Professor of Law at Cleveland-Marshall College of Law will discuss when “settled law” isn’t so settled any more.

Thursday, April 26
Our annual Workout Banker Panel. Sally Barton of Key Bank will moderate, and panelists will be added shortly. This will be a lunch meeting at the Wyndham Hotel.

*Event dates and locations are subject to change