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It would be hard to imagine a better time to publish a special issue on turnarounds. Everywhere we look for the past several months, goals, plans, and projections have come unwound. In our 2007 turnaround issue, we mentioned that American automaker Chrysler was a good candidate to be taken over by a private equity firm to enable its turnaround. How odd that the Chrysler saga has come full circle so that the private equity firm that now owns Chrysler is trying to find an escape from its ownership position. Not only are the “Detroit Three” automakers in trouble, right behind them is a vast sea of parts makers as well. It would be easy if economic woes were limited to just a single sector of the economy, but few areas appear untouched. The selection of articles for this special issue takes you right inside the best thinking on turnarounds at a point in time when the need is real.

The topics are divided among three broad categories: overview articles about general and economic topics; a series of cases; and techniques. As much as we all may want to dismiss the “dismal science” as being just too obtuse to be useful, none of us can escape the effects of economics. This journal’s lead article, by James F. Smith, takes you through a series of important numbers, both past and present, and to everyone’s great surprise, has an uplifting message. The author strongly recommends those who want to learn more read the classic text, “Manias, Panics, and Crashes,” and I heartily agree with this endorsement.

Next up is Hugh Larratt-Smith with a discussion of the deep freeze on the credit markets and the multiple impacts that has had and will continue to have in the coming year. The final article in the overview section, by Hass and Pryor, takes an entirely different tack, and in some detail reviews the essence of what private equity companies do to deliver outsized gains.

We present three case studies, the first written by Ball, Miller, and Stenger about the large-scale turnaround of automotive giant Dana Corporation. At one time this company was one of the true stars of the heavy industry sector, showing that no success lasts long without constant attention to changing markets and technologies. Next up is the story of the turnaround of a steel mill in Pennsylvania as told by Bellardini and Newcomb. Our final case is the turnaround of a wholesale distributor of giftware and collectibles located in Bloomingdale, Illinois, as written by David Bagley.

Our lengthy technique section is led off by Thomas M. Kim’s piece on understanding why private equity groups are wise to consider hiring professional turnaround managers for their troubled portfolio companies. Rather than just a sales talk, Kim presents three brief case studies and a series of lessons, each of which will be valuable if you find yourself
involved with the idea of bringing professional turnaround help into private equity funds.

The next two technique articles stay with “big picture” ideas, starting with Lowell Wallace on the customers’ role in turning around a business and why it is often forgotten. Baker A. Smith provides a sobering view of the role of the inflation that many pundits are saying will be caused by the current economic policies.

We have selected two technique articles on banking. One, by Robert D. Katz, is on how to find financing in today’s radically changed world. David L. Johnson builds on this theme in his discussion of the fundamentally altered distressed financing market.

We think about our customers, our lenders, and the economic environment—but in no way can we forget our employees. David L. Auchterlonie covers the role of team-based incentive compensation and how this approach can have a significantly positive effect on the culture of a company in the midst of a wrenching turnaround.

Ignore the legal environment at your peril. We present four pieces regarding various parts of the legal puzzle in which we all operate. Joseph D. Kenyon writes about the importance of fraud prevention in any turnaround company; Diane M. Pfadenhauer tackles the legal and practical issues of layoffs; Steven J. Weisz writes about cross-border guarantees; and Theys and Paget discuss the methods by which new money creditors may obtain priority ranking.

Taken as a package, these articles present a picture of the current state of the professional turnaround practice. We are grateful to members of the Turnaround Management Association for contributing to this special issue of JPE and especially Cecilia Green of TMA for her wise advice and counsel.

JAMES E. SCHRAGER
Chicago, Illinois
May 2009
ECO NOM IC CONDIT ION S FOR TURN ARO UN DS SHOU LD IMPROVE IN 2009 AND 2010

James F. Smith

The author of this article recommends reading the book Manias, Panics, and Crashes: A History of Financial Crises for reassurance that the likely future path of the U.S. and world economies is up. The book teaches that booms and busts have happened repeatedly, and that economies always come back stronger than before and sooner than most people expect. Monetary and fiscal stimuli cause an end to the panic, a stock market boom, and strong growth in the real economy. If the monetary stimulus is removed quickly after the boom, steady growth results. If not, then inflation and another recession ensue. The author expects the authorities to engineer a successful turnaround for the U.S. and world economies, which will be good for private turnaround managers.

YOU BRING THEM A CHEST OF GOLD, THEY TELL YOU IT’S TOO HEAVY

Hugh C. Larratt-Smith

Things were very smooth when the economy was expanding at a rapid clip. Companies and private equity groups added leverage at every opportunity. Liquidity was abundant. Now, politicians are saying that banks are hoarding capital—and banks are saying that they want to lend money, but qualified borrowers are not knocking on the door. One thing is clear: the deep freeze in the credit markets will not thaw quickly.

WHAT PUBLIC COMPANIES CAN LEARN FROM PRIVATE EQUITY: Pursue the Value Journey

William J. Hass and Shepherd G. Pryor IV

This article provides important guidance based on the authors’ study of top value builders from both public and private equity-owned corporations. They observe that a wide range of effective application of value-building fundamentals among public and private companies exist. A disciplined approach to value building is the prime factor of differentiation between success and failure. As a result, both public companies and private equity portfolio companies have significant room for improvement. Four major steps of the value journey provide guidance to top value builders in good times and bad.

LIBERATING A BUSINESS FROM ITS HISTORY: The Turnaround of Dana Corporation

Corinne Ball, Henry Miller, and Ted Stenger

When auto-parts maker Dana Corp. was near collapse, restructuring professionals entered the scene and effected a comprehensive reorganization of Dana’s global business. They facilitated negotiations between various stakeholder groups and utilized the Chapter 11 bankruptcy process strategically, resulting in a restructuring that included groundbreaking deals to limit Dana’s liabilities for retiree welfare benefits and pension plans; the divestment of noncore businesses, both domestic and overseas; the institution of a pan-European receivables securitization facility; the out-of-court reorganization of its European operations, avoiding insolvency proceedings in multiple jurisdictions; the restructuring of a struggling finance subsidiary; and the renegotiation of unfavorable contracts with Dana’s significant OEM customers. Dana emerged from the process with a competitive cost structure, rationalized manufacturing footprint, and streamlined corporate organization, in stark contrast to the well-publicized difficulties of other auto industry participants.

FINDING “INNER STEEL”: A Pennsylvania Company’s Remarkable Rebirth

John J. Bellardini and Walter C. Newcomb

In 2002, Michelman-Cancelliere Iron Works of Bethlehem, Pennsylvania was a respected provider of structural steel for large infrastructure projects in the Northeast. Four years later, MC Iron faced extinction with significant financial losses. With its willingness to persevere and the strength of an exceptional turnaround team—JC Jones & Associates—MC Iron found the “inner steel” to make the deep, lasting changes needed to turn a losing operation around and ensure long-term success. The path was painful but in little more than a year, recovery was complete and MC
Iron is a different business. This case won the 2008 Small Company Turnaround of the Year Award from the Turnaround Management Association.

**Roman, Inc.: From Liquidation Planning to Turnaround of the Year**  
**David Bagley**

Roman, Inc., a mid-sized wholesale distributor of giftware, seasonal décor, and collectibles located in Bloomingdale, Illinois, was in the process of closing down when it engaged MorrisAnderson to maximize value from the liquidation. Dave Bagley, managing director with MorrisAnderson, assisted CEO Dan Loughman and COO Pat Pipp in developing a business plan that rejuvenated the company. Roman was transformed from annual losses of $3 million to profits of $2 million. In 2008 Roman was awarded the Turnaround Management Association (TMA) Chicago/Midwest Chapter’s Medium Turnaround of the Year award, and the TMA International Mid-Sized Turnaround of the Year, Honorable Mention.

**Turnaround Candidates in PEG Portfolios: Hear No Evil, See No Evil Is Not a Good Strategy**  
**Thomas M. Kim**

With the current economic downturn, many private equity groups (“PEGs”) will have to manage portfolio companies that are in distress. Many PEGs will attempt to manage their underperforming companies themselves. This will create a significant burden on the PEGs’ resources and potentially lead to greater problems in their portfolio as a whole. The author states his case for why PEG managers ought to consider retaining qualified and experienced turnaround managers capable of assisting them with their underperforming portfolio companies. The author notes that turnaround managers have experience working with PEGs, understand their challenges, and have the skills necessary to provide expert assistance under difficult conditions.

**The Role of the Customer in Turnarounds**  
**Lowell C. Wallace**

This article takes a look at how the customer can be the key to the successful turnaround of a distressed business in any category. It presents the argument that one reason so little attention is paid to the customers is that they are often seen as the reason a business slips into a distressed state, rather than the cure. In reality, customer defection is a symptom of distress, not its cause. The article presents primary examples of successful turnarounds that relied on the customer from the automotive aftermarket and a distributor of machine tools.

**Why I Stopped Drinking Milk: The Impact of Commodities and Currency Pricing on Restructurings**  
**Baker A. Smith**

Companies facing the twin dangers of rising commodities prices and declining United States currency values are experiencing unexpected threats to their very survival. Inflation is wreaking havoc in a more complex and destructive manner than the conventional concern with consumer prices. The impact can be so sudden that companies that have been steadily profitable for years can find themselves in a struggle for survival in a matter of weeks. Now more than ever, private equity sponsors and lenders may need to consider the causes of a sudden decline if intervention by a financial advisor is to be timely and effective.

**Credit and Liquidity: Where Have You Gone? How and When Can We Get You Back?**  
**Robert D. Katz**

Less than a year ago, if you existed and had a pulse, there was somebody who would consider investing or loaning to you, prosperous or not. That was before the Dow Jones Industrial average lost over 50% of its value and icons of the investment banker world—Lehman Brothers, Bear Stearns, Merrill Lynch—and the commercial banking world—Wachovia and
National City among others—were a mere memory. With liquidity all but dried up, it begs the question: “Credit and liquidity: Where have you gone? How and when can we get you back?” This article will provide some insight about which rocks to look under and how to convey your message to the new and reduced audiences. Don’t totally give up the ship; there is some hope.

**THE CHANGING SHAPE OF DISTRESSED FINANCING:**
**Trends Driving the Evolution of a Market**

DAVID L. JOHNSON

In recent years a confluence of trends have become manifest in the distressed financing environment that are likely to substantially alter that market. Banks and commercial finance companies now face powerful incentives to more carefully monitor their credit risk. New market-based opportunities exist that will enable these traditional lenders to curtail exposure while simultaneously creating a more active role for alternative investment firms. Extrapolating from current trends, it is possible to discern the outlines of a fundamentally changed distressed financing market.

**TEAM-BASED INCENTIVE COMPENSATION IS VITAL TO SUCCESSFUL OPERATING TURNAROUNDS**

DAVID L. AUCHTERLONIE

In recent months, greedy executives have given pay-based bonuses a bad rap. That’s unfortunate, because incentive compensation is a vital, essential, and frequently overlooked tool when it comes to turning around a poorly performing company. This is especially true when the focus is on employee incentive compensation. If substantial improvement is to be made to a struggling company’s EBITDA, a seismic change in the entire corporate culture must take place, starting at the grassroots level where employees work. A turnaround plan that incorporates team-based performance and results-based incentive bonuses for managers and employees can create amazing results in a financially challenged company.

**INVESTORS, TURNAROUND PROFESSIONALS, AND FRAUD: “First Do No Harm”**

JOSEPH D. KENYON

Businesses in transition, whether from a sale, unusual growth, or a turnaround situation, may be at increased risk for fraud. Investors need to understand how to spot the red flags of fraud when they become involved with a new business. Additionally, it’s important to understand, as changes are made to the business, what new conditions can create a motivation or an opportunity for fraud. This article also addresses how to create a fraud prevention and detection system.

**SELECTION AND COMMUNICATION IN LAYOFF PLANNING:**
**The Cornerstones of a Successful Reduction in Force**

DIANE M. PFADENHAUER

The availability of a tremendous amount of literature addressing the legal issues associated with conducting a layoff influences many practitioners to rely solely on the legal elements. While indeed these are important, an effective layoff cannot be achieved without focusing on two additional major elements: selection of individuals for layoff and communication to various stakeholders. By utilizing a layoff committee that includes diverse representation throughout the process, the organization is better prepared to achieve the organizational objectives outlined in the layoff plan.

**RECENT CASE LAW ON CROSS-BORDER GUARANTEES**

STEVEN J. WEISZ AND BETH E. POSNO

Two recent cases decided under the Companies’ Creditors Arrangement Act highlight some potential snags in coordinating U.S. and Canadian insolvency proceedings. In both cases, the Canadian debtors had guaranteed the obligations of their U.S. affiliates, in one case under a secured loan and in the other under a debtor in possession loan. These cases illustrate how the Canadian courts are dealing with the issue of cross-border guarantees and the extent to which they are concerned that the interests of Canadian unsecured creditors be considered.
New Money Priority Ranking:
A New Tool to Invest and Restructure Underperforming Companies

Nicholas Theys and Stéphanie Paget

New money priority ranking enables creditors to obtain priority ranking if they invest in an underperforming company which is undergoing a conciliation procedure.

The creditor must contribute new cash, goods, or services with a view to insuring the continuation of the company’s business activity, and these contributions must be agreed to in a ratified agreement. The ranking grants priority before all debts arising before the commencement of the conciliation procedure, just after wages and salaries and legal costs. Thus, new money appears to be a valuable tool for the refinancing of companies facing difficulties.
Economic Conditions for Turnarounds Should Improve in 2009 and 2010

JAMES F. SMITH

It’s a hard, cruel world out there, with much economic turmoil and concern. On August 9, 2007, the huge French bank BNP Paribas (one of the 10 largest in the world with assets in excess of $1.3 trillion) told owners of shares in three of its mutual funds they could not redeem them “because we own bonds based on U.S. sub-prime mortgages that we can’t put a value on right now.” Since that day, financial panic has spread around the world.

Nothing makes an investor madder or more scared than being unable to cash out his or her investment from a fund. This problem has recurred many times throughout history. A comprehensive documentation that is also a most delightful and interesting book to read is Manias, Panics, and Crashes: A History of Financial Crises (5th Edition) by Charles P. Kindleberger and Robert Aliber (ISBN 978-0-471-46714-4). This wonderful book has always been a huge hit with my MBA students in the second-year elective courses in which I’ve used it. It covers the history of financial panics around the world from Kipper-und-Wipperzeit of 1619–1622 and the Dutch tulip bulb episode in 1636–1637 through the Asian collapse in 1997, as well as the Russian default and the collapse of Long Term Capital Management in 1998 and the corporate scandals of 2001–2003 (Enron, WorldCom, and so on). The Wall Street Journal’s lead editorial on September 16, 2008, “Surviving the Panic,” referred to the usefulness of this book in understanding the current situation.

Few people were sorry to see 2008 pass into history at the stroke of midnight on December 31. Almost all of the data coming out so far in 2009 have done absolutely nothing to disabuse anyone of that “good riddance” feeling. For example, on February 27, the Bureau of Economic Analysis (BEA) of the U.S. Department of Commerce gave us the second (“Preliminary”) set of numbers for the gross domestic product (GDP, the total value of all the goods and services produced within the borders of a country) for the fourth quarter and entire year 2008. This made very dismal reading.

Real (meaning adjusted for price changes) GDP shrank at a seasonally adjusted annual rate of 6.2% in the fourth quarter of 2008. That was revised downward from the original estimate of 3.8%, which would have been a tie with the third quarter of 1974 for the 12th worst performance since the second quarter of 1947, the year when quarterly data for GDP began. Now it ranks as tied with the fourth quarter of 1953 for the fourth-worst quarterly decline since then.

For the full year 2008, real GDP rose 1.1%. That’s the worst performance since 2001, a year which had eight months of recession in it.
What no one seems to remember is that the five years 2003 through 2007 were quite good for the U.S. economy. They were even better for the world, as those were the best five consecutive years for global economic growth ever recorded. Not coincidentally, the number of people lifted out of poverty (defined globally as having a cash income of less than $1.00 per day) was in the hundreds of millions around the world. That's also a five-year record.

The U.S. saw fourth-quarter 2008 real GDP fall 0.8% below a year earlier. Total real personal consumption expenditures (PCE) in the fourth quarter were 1.5% below a year earlier. For the full year they were only up 0.2%, the lowest increase in over 25 years. As a result, real PCE declined to 71.0% of real GDP in 2008. It had been 71.6% in 2007.

Total industrial production, the output of the nation's factories, mines, and utilities, fell sharply in 2008. According to the Federal Reserve Board, it was down 7.8% in December from December 2007.

On February 13, Eurostat shocked observers with its first (“Flash”) estimates of GDP for the full 27-nation European Union and the 15 countries that were in the Euro Zone during 2008. Slovakia became the newest country to join the Euro Zone on January 1, 2009.

Both the European Union (EU) and the Euro Zone contracted by 1.5% quarter-on-quarter (6.0% annualized) in the fourth quarter of 2008, the sharpest decline since the end of World War II. The EU saw total real GDP fall 1.1% from the fourth quarter of 2007. The corresponding drop for the Euro Zone was 1.2%. For the full year 2008, the EU grew by 0.9% over 2007. The Euro Zone figure was 0.7%.

Japan is the world’s second-largest economy. It is in a deep recession and indeed has posted little economic growth since the collapse of its “bubble economy” in 1990. It has very little room for any fiscal stimulus because its federal debt-to-GDP ratio is about 190%. Thus its debt service, even at its low interest rates (1.29% on 10-year government bonds on March 9), means that the government must spend about 3.2% of nominal GDP on paying interest to bondholders. As the Japanese economy has not grown by more than 3.2% in nominal terms in 20 years, that means the debt ratio will just keep growing forever until their economy collapses unless they start paying down debt soon. That’s a truly scary situation.

CONSTRUCTION SPENDING UP IN 2008, BUT WILL FALL IN 2009

Total construction spending in the United States was $1.07 trillion during 2008, only 5.5% less than the $1.14 trillion spent in 2007. That was 7.5% of total GDP. Full details can be found on the Census Bureau website at http://www.census.gov/const/www/c30index.html.

Total private construction spending was $766.9 billion in 2008, down 9.8% from 2007. The big hit was to residential construction spending, which fell to $356.0 billion, 27.7% below 2007. As housing starts fell all year long, housing completions are bound to decline at least through the first half of 2009. What held up private construction was nonresidential building. Some $410.9 billion of projects were completed in 2008, a huge increase of 14.9% over 2007.

We won’t be so lucky this year. Overbuilding in the face of declining demand, coupled with the drying up of credit for commercial real estate, will cause these numbers to collapse in 2009. It may be 2013 before we see the 2008 total exceeded.

Private nonresidential construction spending did not peak until September 2008. The biggest spending increases over the year were in manufacturing facilities (up a huge 49.9% from 2007), power generation (up 44.6%), and lodging (up 31.9%). All will be down in 2009.

The public sector spent $307.8 billion on construction projects completed in 2008. That was up 7.3% from 2007. Construction of public educational buildings was $85.4 billion, up 7.7% from 2007. Highway construction was $80.3 billion, an increase of 6.3%. Public sewage and waste disposal and water supply project spending was $41.3 billion in 2008, up 4.8% from 2007.

All of these categories should get a boost from the stimulus package enacted in February 2009. That ought to absorb some of the slack from the decline in private construction spending in 2009 and 2010.

TRILLIONS OF DOLLARS OF STIMULUS ALREADY IN THE PIPELINE, AND MORE IS COMING

Two primary types of economic policy speed up or slow down the rate of economic growth. These are monetary policy, which is the province of the central
bank, and fiscal policy, which is conducted by the elected officials of the executive and legislative branches of government. Both levers are being pulled hard in the United States, Canada, China, the U.K., and other major countries around the world.

The Federal Open Market Committee (FOMC, the part of the Federal Reserve System that controls monetary policy) was slow to realize the impending doom caused by all the problems arising from the mortgage markets, especially subprime mortgages. It did not begin to cut the target for the Federal Funds rate from the 5.25% level they raised it to on June 29, 2006, until September 18, 2007. These actions created an inverted Treasury yield curve from June 2006 to July 2007, which for the 18th consecutive time since 1901 signaled the coming of recession for the U.S. economy. After that, the rate target was cut dramatically to a range of 0.0 to 0.25% on December 16, 2008.

Sadly, many people (including a lot who should know better) expect quick results from these actions. However, one of the three primary tenets for which the late Milton Friedman was awarded the Nobel Memorial Prize in Economic Science in 1976 was “monetary policy operates with long and variable lags.”

What this means is that actions of the FOMC (or any other central bank) take a long time to have their maximum impact on the real economy. In the U.S., this lag is normally around 2.5 years. It’s never been shorter than one year or longer than three years since 1951. That suggests the big push from lower interest rates won’t show up until 2010 and 2011. By then rates probably will be rising again.

Since the Federal Reserve can’t lower the target for the Federal Funds rate any further, it has employed an unprecedented form of monetary stimulus known as “quantitative easing,” which means increasing the money supply by buying up assets in exchange for checks (actually, electronic credits). This works because the Federal Reserve can issue checks without any practical limit and they can’t bounce.

So far, the Fed has increased its balance sheet from about $800 billion when the panic began in August 2007 to nearly $2.5 trillion from October to the end of 2008 and about $2.0 trillion today. The Fed made it very clear that it will continue to do this until it sees clear signs of an economic recovery. The Bank of England is following the same path.

We are all fortunate that the current chairman of the Board of Governors of the Federal Reserve System is Ben Bernanke. When he was an academic economist, he made much of his reputation from examining the causes and consequences of the policy mistakes that turned what should have been the recession of 1929–1930 into the Great Depression that ran from August 1929 until March 1933.

The biggest reason for that was the failure of the Federal Reserve System to realize that when banks fail in a regime in which there is no deposit insurance, the money supply shrinks. This led directly to deflation and a dramatic reduction in the economy. We did not get deposit insurance in the U.S. until the creation of the Federal Deposit Insurance Corporation in 1933.

Nominal GDP was $103.6 billion in 1929 and only $56.4 billion in 1933. That’s a fall of 45.6%. That was serious deflation. It was 1941 before GDP exceeded the 1929 level.

Because prices were falling, the drop in real terms was less. Measured in 2000 dollars, real GDP was $865.2 billion in 1929 and $633.5 billion in 1933. That’s a drop of 26.5%. Real GDP exceeded the 1929 peak in 1936 at a level of $866.6 billion.

The second giant policy blunder was the Smoot-Hawley Tariff. This raised duties on imported goods to 49.6% (the highest in U.S. history) and caused world trade to implode by two-thirds from January 1929 to January 1933. The third mistake was raising taxes. This was in a vain attempt to reduce the deficit. This was in a vain attempt to reduce the deficit.

It’s unlikely that any of these mistakes will be repeated. There is a lot of talk about protectionism, but with luck that won’t become a huge problem.

**FISCAL STIMULUS KEEPS GROWING**

The U.S. has been pouring on new government spending for over a year now. The first effort was the “Economic Stimulus Act of 2008,” which was signed into law by President Bush on February 13, 2008. That provided $168 billion, about $100 billion of which was payments of $600 per person or $1,200 per couple with adjusted gross incomes below $75,000 per person or $150,000 per couple. That resulted in real GDP growth at a seasonally adjusted annual rate of 2.8% in the second quarter, so it apparently worked as a short-term stimulus.
Next came the “Emergency Economic Stabilization Act of 2008,” which President Bush signed into law on October 3, 2008. That provided $350 billion immediately to be used for bank “bailouts” and other purposes such as loans to Chrysler and General Motors. A second $350 billion was released by Congress in January, and new Treasury Secretary Geithner is still deciding how to use it.

Congress passed the “American Recovery and Reinvestment Plan” on February 13. The total is estimated to be $787 billion over the next 18 months. President Obama signed it into law in Denver on February 17. It contains $27.5 billion for highways and bridges and more than $140 billion in transfers to state governments, some of which will also add to infrastructure spending, although most of it will go to Medicaid. However, this seems paltry compared to the needs for improvement in infrastructure after 30 years of underfunding maintenance and repair. We spent $80.3 billion on highways in 2008.

On January 28, the American Society of Civil Engineers (www.asce.org) released a report detailing the necessity of spending $2.2 trillion over the next five years to get airports, bridges, dams, highways, ports, railroads, schools, transit, and water and sewer systems up to modern standards. In a time when no one is concerned with the deficit and nearly all members of Congress agree on the need to improve the infrastructure of the U.S., it would seem that the stimulus package should have included at least $880 billion to fund the first two years of this effort. The rest could be added in new legislation later.

Consumers and businesses are also benefiting greatly from the huge decline in oil prices. Every $10 a barrel drop is worth $47 billion to U.S. consumers. That's the equivalent of a tax cut in excess of $300 billion a year. Of course, that's a mixed blessing in oil-producing states such as Oklahoma and Texas.

Reading Manias, Panics, and Crashes will convince you that whenever massive resources are thrown at ending financial panics, three things have always happened in every country that has done it:

1. The panic stops. Since this one has been going on since August 9, 2007, which makes it the longest panic since the Great Depression of August 1929 to March 1933, it will be really good news when it happens. We'll know that day has arrived when the spread between the 3-month U.S. dollar LIBOR (London Inter-bank Offered Rate) and the 3-month U.S. Treasury bill yield returns to its normal range within 3 to 5 basis points. On March 9, 2009, LIBOR was 1.31% while the 3-month Treasury yield was 0.21%, a gap of 110 basis points.

2. Stock markets boom. All that liquidity has to go somewhere, and the best returns on investments are in stocks over the long run. This should occur in 2009, although that seems far off with the markets having hit 12-year lows on March 9.

3. With a lag of only a few months, the real economy soars—the parts that produce goods and services. The huge growth in real GDP from the end of 1982 through the second quarter of 1984 shows this (real GDP grew at seasonally adjusted annual rates of 5.0, 9.3, 8.1, 8.4, 8.1, and 7.1%, respectively, over those six quarters). Real GDP grew by 7.2% in 1984 (after a 4.5% increase in 1983), the best year since the 7.7% of 1951 and still the third-fastest growth rate since the 16.4% of 1943. The 8.7% real GDP growth rate in 1950 is the post-1943 high.

THE FOMC’s ACTIONS ARE CRUCIAL

The late William McChesney Martin, the longest-serving Chairman of the Fed, once famously said that the main job of the central bank was “to remove the punch bowl just when the party is going good.” That is a most apt description of the challenge.

If the FOMC moves quickly to remove the excess liquidity it has created since 2007, then a long growth period with low inflation is likely to follow. The FOMC did this very successfully after the July 1981 to November 1982, the July 1990 to March 1991, and the March to November 2001 recessions. That's why the period since the 1981–1982 recession is known as the “Great Moderation.” It's been a period of relatively stable growth with low inflation. Real GDP growth has been positive in 96 of the 104 quarters (26 years) through 2008. That's a ratio of growing-to-shrinking quarters that is unprecedented in U.S. history.

When the FOMC has been too slow to sop up the excess liquidity, then inflation becomes a problem and another recession is needed to bring it under control. This is what happened after the December 1969 to November 1970, the November 1973 to March 1975, and the January to July 1980 recessions. That's the reason...
why that period is known as the “Great Inflation.” It took the long and deep 1981–1982 recession to get inflation expectations and inflation itself under control.

One major goal of the FOMC is to achieve price stability. By this it means a rate of inflation so low that businesspeople and consumers do not worry about inflation when making economic decisions.

The good news here is that most central banks around the world either have “price stability” or specific inflation targets. For example, the Bank of Canada has a goal of keeping inflation within a range of 1%–3%. The ECB has price stability as its only goal.

The fact that most central banks have these targets should encourage the FOMC to take the necessary steps to prevent inflation. If it were to fail, that would probably mean a collapse in the value of the U.S. dollar against most foreign currencies. That would mean the FOMC would have to raise the target for the Fed Funds rate, which would cause an inverted yield curve for Treasury securities. As mentioned before, that’s an infallible sign of an impending recession and the U.S. economy would soon be in trouble again. No one wants to see that.

WE’RE ALL WATCHING FOR EARLY SIGNS OF A RECOVERY

One of the most cyclical industries in most countries is residential construction. In the U.S., it nearly always turns down before the recession starts and is one of the very first industries to rebound. This is because it’s the sector of the economy most sensitive to interest rates.

As you might guess, the part of housing starts most reactive to interest rates is single-family residences. During 2008, there were only 904,300 total housing starts in the United States. In December, single-family units hit their lowest point of the year at 398,000 units at a seasonally adjusted annual rate. The annual total was only 569,900 houses. That level of single-family starts was lower than any year since 1942–1945. During these years, most materials used in building houses were diverted to the successful effort to win World War II.

The sales of new homes in December hit a low of 344,000 units at a seasonally adjusted annual rate. January 2009 was 10.2% below that at a truly dismal seasonally adjusted annual rate of 309,000. It seems most likely that the remaining months in 2009 will be higher than that.

Mortgage rates are at 38-year lows. One large custom homebuilder, Toll Brothers, attracted considerable attention in January with a guarantee to buyers of a 3.99% 30-year fixed rate mortgage.

Existing home sales in one of the states hardest hit by the housing crisis, California, rose 26.7% in 2008 from 2007. That could be a harbinger for the nation in 2009.

Underlying demographic demand suggests single-family starts should be around 1.3 million units a year. We’re a long way below that now.

The second area to pick up should be vehicle sales. This is also a very credit-sensitive sector. It hit a low of 9.1 million units at a seasonally adjusted annual rate in February 2009. That was the poorest performance since December 1981.

The third thing that should pick up is consumer confidence. The Index of Consumer Sentiment, which has been compiled by the University of Michigan since 1946, did creep up to 61.2 (March 1966 = 100) in January from 60.1 in December. That’s not much, but it was at least a move in the right direction. However, it dropped to 56.3 in February. That’s discouraging. It’s the lowest since last November.

The Small Business Optimism Index should come next. It was 84.1 (1986 = 100) in February. That’s the second lowest in the 36-year history of the survey. It was only lower in the 1980 recession.

It will be some time before employment growth picks up. That is a lagging indicator, although job losses should be much less than 500,000 a month soon.

Commercial real estate investment has long lags. It would appear that it did not peak until September 2008 at an annual rate of $426.9 billion. Given the collapse in credit availability for commercial real estate and the huge supply coming on-stream in most sectors, it could easily be 2013 before we see significant increases in this area of construction.

If banks, insurance companies, pension funds, and other traditional lenders do not soon pick up the pace in making loans for all sectors of commercial real estate, then we should expect to see the Federal Reserve step in forcefully. They will buy or make loans against existing portfolios of commercial real estate loans in order to get that huge credit market to return to functioning normally.
We could easily see real GDP growth of 0.9% in the U.S. and 1.0% in Canada in 2009. The consensus is for small declines in both countries. They will both pick up significantly in 2010, with the U.S. at 3.4% and Canada at 2.5%. The first country to turn up should be the U.S., followed by China then Canada.

The success or failure of stimulus packages in the U.S. and other countries will have a lot to do with the outcome, or at least the details of final demand, as they would be different without all the government spending. Stay tuned!

ENDNOTES

1Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.

2Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovenia, and Spain.

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You Bring Them a Chest of Gold, They Tell You It’s Too Heavy

HUGH C. LARRATT-SMITH

On June 17, 1931, the Norddeutsche Wollkammerei, one of Germany’s largest wool enterprises, declared bankruptcy, announcing losses amounting to $50 million from inventory fraud. On July 5, 1931, a Swiss newspaper suggested that a large German bank was in trouble. On July 6, 1931, Germany’s third-largest bank, the Danatbank, denied it was having difficulties. On July 8, 1931, Danatbank informed the Reichsbank that it could not meet its liabilities. This followed on the heels of the May 1931 bailout of Credit Anstalt in Vienna, the largest bank in Austria.

By July 14, 1931, the great banking house of Lazard was in trouble. A rogue trader had made a wild bet on the collapse of the French franc, and had lost almost double the bank’s capital. When confronted by the loss, the trader pulled out a gun and shot himself in front of his colleagues in the office. The Bank of England agreed to bail out Lazard, as well as two other leading British investment banks, Schroders and Kleinworts. The postscript to all of this was, as we know, the Great Depression.

Fast forward to today. Fears about the collapse of Austria’s banks have dominated headlines in Europe. Heavy exposure to emerging Eastern European countries by Austria’s banks may lead to an unraveling of the European Union, as EU members fight over who should bail out Austria’s banks. The U.S. banking system is in disarray. Indeed, the OECD recently noted in its Interim Economic Outlook that “the world economy is in the midst of its deepest and most synchronized recession of our lifetimes.”

The liquidity problems for banks in 2008 have now become corporate default problems for banks in 2009. The past year was “the worst year in the history of the high-yield market for price declines in junk bonds—by a huge margin—and quite possibly the worst year of all time in the capital markets history of this country,” according to analysts at Citigroup. The price declines were triggered by fears of escalating defaults. This promises to be a tough year for junk bond defaults and stalled maturities. The sheer amount of junk bond maturities in 2009 will test the fortitude and patience of lenders in the next 12 to 24 months. Indeed, with the worst job losses in 45 years, corporate defaults are rapidly accelerating.

Banks are struggling to navigate the various cross-currents between Wall Street and the Washington D.C. Beltway politics. Some politicians are complaining that the banks are hoarding capital—yet with the recession headed into its second year, and indeed, shaping up to be the worst downturn since World War II, banks can be forgiven for shoring up their reserves. Bank lending dropped 55% in 2008, according to The New Yorker. At every conference and industry...
lunch across America, you hear the same thing: no deals are getting done.

Compounding the liquidity tightness in the credit markets are concerns of how capital structures will fare in an economic slowdown. Compared with the last two downturns in 2001 and 1992, today’s capital structures are like wedding cakes with numerous layers and many flavors. Indeed, one industry pundit suggested that comparing today’s capital structures to those 10 years ago is like comparing a Picasso painting hanging in The Louvre to the portrait of George Washington hanging in the National Gallery in Washington.

There’s been a lot of teeth-gnashing by lenders about balance sheets that have become so complicated and aggressively structured. There’s an old saying that you meet the same people on the way up as you meet on the way down. With loan structures, some of the terms and conditions that amplified the credit crunch are now amplifying the credit crunch.

However, unless a company has been forced to refinance in the past 12 months, and in the process, take on a more conservative capital structure, its balance sheet may still resemble this multi-layered, multi-flavored wedding cake. Indeed, many borrowers are still enjoying the fruits of the unprecedented liquidity in the 2003–2007 period when capital was raining down from the clouds.

Some long-standing relationship borrowers are getting shown the exit doors through no fault of their own. In many cases, the lender’s capital tightness prevents it from funding the loan. Even some strong borrowers are saying that when they ask for new credit from some lenders, they feel like “you bring them a chest of gold and they tell you it’s too heavy.”

“Similarly, if a lender has limited capital to lend, having a performing borrower may not be enough if the borrower’s risk profile is higher than the profile of other borrowers or potential borrowers of the lender,” says Roger Chari, an attorney with Hahn & Hessen in New York. “The tighter credit standard might come voluntarily from the lender’s credit committee, or involuntarily from the lender’s funding source.”

In each of these cases, a performing borrower that trusted its lender in good faith to be “commercially reasonable” in administering the loan can find itself scrambling to get other financing on short notice and prevent its own bank’s financial difficulties from ruining the business.

Some borrowers will go to extraordinary lengths not to refinance or change the terms of an existing deal.

As we all know, in September 2008, the world changed. Loan pricing went through a dramatic (and many lenders will say a welcome and long-time-coming) uplift. Loan structures tightened. Today, the job of being an agent can be tough. A modest request by a borrower, such as incorporating a new subsidiary, can be met by a disproportionate response by the lender group. At any opportunity, lenders want to reprice or recovenant a loan.

Some lenders are now reining in borrowers who were positioned for rapid expansion and haven’t throttled back growth plans. Many buyouts in the last two years were built on aggressive growth in order to justify big multiples. Lenders were invited to “step aboard the [EBITDA] rocket ship to the moon,” and now the second and third stages of the rocket haven’t fired and are losing altitude. Yet management may be reluctant to admit that the growth will not materialize, or, in fact, the tide has reversed.

In particular, numerous companies haven’t cut back on head office overheads, new product development, or other growth elements of their cost structure. Some lenders find themselves confronted by tough choices. Management is telling the lenders that aggressive marketing spending is needed to goose sales, yet lenders look at “soft” CAPEX as a potential black hole for liquidity. We saw one giftware company that spent a fortune on a 2008 Christmas catalogue that got delayed because the printer didn’t get paid in advance. When the catalogue arrived a month late in the customers’ mailboxes, many customers had gone elsewhere.

Many “growth” company management teams have not lived through a deep recession before and are behind the curve when it comes time to cut costs. One common theme in underperforming companies is that management can’t believe how fast a downward spiral can accelerate. A common refrain of management is “we can’t do those cuts—they’re too close to the bone.” In some instances, the company’s business model has changed dramatically, and all spending needs to be completely re-evaluated.

Indeed, one hedge fund lender told us that in 2006, with 100 of his C&I loans, most borrowers were ahead of plan. Today, a company that is ahead of plan is the exception.

**THROWING THE KEYS ON THE TABLE**

We are now starting to see private equity groups “throw the keys on the table” on deals where they’re
out of the money. While this is not what lenders want to hear, the situation is partially mitigated if the private equity group agrees to move out of the way quickly. When a private equity group delays the inevitable, or becomes obstructionist, then no one wins. There are some instances where the lenders look to the legacy owners (who usually rolled some of their original equity into the new equity) to step back into the game with some fresh equity and management expertise if the private equity group bails.

In the late 1990s, any banker who managed to get a private equity group to consent to a capital call would get high fives as he/she walked down the corridor of the office. Fast forward to today: Some lenders have hit the capital calls, only to be told by the private equity group that some of its limited partners can’t fund. Some limited partners have been crushed by the equity and real estate markets or have seen liquidity impaired by the auction rate preferred debacle in 2008.

Another problem with capital calls is that they appear to be a good solution when they’re inked, but heavy negotiations always seem to take place when they’re hit. Some private equity groups view the capital call notification from lenders as simply another opportunity to open up further negotiations.

What happens when a member of the lending group can’t fund an obligation under the credit agreement? The defaulting lender says “sorry, I have no new money—I’m battling redemptions and have zero liquidity!” If there’s a defaulting lender provision in the inter-creditor agreement, then the other lenders can force the defaulting lender to take a haircut. But there are some inter-creditor agreements that don’t have defaulting lender provisions, so there’s a stalemate. The average hedge fund lost 23% in 2008, according to data from Hedge Fund Research—some firms losing more than 60%—as crumbling markets and a wave of client redemptions took their toll. Lender defaults could accelerate in 2009 and 2010, despite some hedge funds raising the ramparts and blocking redemptions.

BORROWING BASES—A BIG QUESTION MARK

In the first two quarters of 2009, some senior lenders are getting more nervous as collateral values weaken. Up until now, senior lenders could be somewhat sanguine about weakening financial performance because collateral was holding up.

One area showing some cracks is collateral, including commodities such as steel, lumber, or oil. These types of borrowing bases can be very worrisome to lenders when reporting is on a monthly or even weekly basis.

Ugly surprises are starting to happen: a lender gets a monthly borrowing base and realizes that the borrower now has a major over-advance. (Indeed, many metal operations have borrowing bases that are “white-knuckles” ever since metals prices began their collapse in 2008.) Likewise, appraisal updates on machinery and equipment are way, way down. These downward forces have become big obstacles in companies’ refinancing strategies.

2006—A YEAR TO FORGET

2006 was a year that many lenders wish never happened. Why? Because in the market froth, loan agreements became so weak that when the yacht started to burn, the Coast Guard firemen were powerless to do anything about it. Some lenders are now watching the yacht burn to the waterline.

Some senior lenders are locked in loan agreements that were not drafted by the attorneys representing the senior lenders, but by the attorneys of the borrower under the careful watch of the investment bank putting the deal together. In certain cases, the investment bankers were telling the senior lenders which law firms the senior lenders were allowed to use. As a result, the senior lender’s powers were subtly restricted in ways that are now coming back to haunt the lenders.

Things could get more ugly in 2009 and 2010. Revolver lenders will be saying, “I won’t do anything more, and I’m cutting back on the revolver by increasing reserves, forget any talk of over advances.”

The slowdown in the economy is translating into lower EBITDA, tighter profit margins, and lower multiples, whether debt or equity multiples. In 2008, mezzanine and subordinated debt lenders were starting to get nervous with tightening cash flow. In some cases, it was debatable whether they would be in the money once the 2008 financial results rolled in. Then, it was the second-lien lenders who started to feel some pressure as the fulcrum security moved up the balance sheet. Now, traditional lenders are starting to see cracks in their portfolios. As the bicycle loses speed, it starts to wobble.
The scarcity of new loans in the marketplace has been partially caused by the secondary market for bank loans crowding out the new loan marketplace. When a lender can buy a LIBOR + 4% loan with four years average life that is yielding 15% in the open marketplace, why do a new loan? Many lenders feel better about buying the secondary loan of a proven company versus the new loan of a company whose performance may be unproven.

Another reason for the scarcity of new financing is that there is little amortization of many loans, so there’s minimal run-off or churn in the portfolio. With 1% in annual amortization, many lenders are frozen in the capital structure.

**STRANGE BEDFELLOWS**

As the decade wore on, lenders beefed up their syndication desks, which became very effective at laying off risk. Capital pools such as CLOs became increasingly active in the commercial finance marketplace, often buying $5 million or $10 million slices of syndicated deals with little due diligence. Their investment philosophy was simple: if they bought large numbers of small participations, then diversification would take care of the rest. (It was the classic portfolio theory. But as with many theories, it has not stood up well in practice.)

Consequently, many syndicated loans have an agent who holds very little of the deal. In larger syndications, armies of CLOs may boost the majority of participants in a deal, which can make restructuring very difficult. Adding to this problem is that most CLOs have no new capital to invest in a restructuring—all they can offer is a deferral of interest and principal, and to waive defaults. This lack of “dry powder” means that CLOs may not be in a position to hire professionals to assist with any restructuring. The CLO may compensate for this by simply being obstructionist. Added to this is the compensation structure for management of many CLOs that incentivizes management to avoid defaults/write-offs, and keep the management fees coming.

There are signs in the marketplace that some hedge funds are trying to corral orphaned participations in a transaction with a view to gaining control, or at least a seat at the bargaining table. This is particularly vexing to second-lien lenders, who may not relish the idea of a bare-knuckles brawl with lenders who have a completely different set of objectives.

Other trouble spots occur when a lender group has lenders who bought into the deal at a price below par. What happens when one party thinks the loan is worth 98 cents, and others think it’s worth 68 cents, based on their valuation of the business? That’s when all of the parties may be exposed to some potential weaknesses in the inter-creditor agreements. How about a senior bank group consisting of a traditional bank, a second-lien shop, and a private equity group that is a “loan-to-own” player? Or the senior lender who went into the original deal at par, and gets a call from someone on his bank’s distressed trading desk who just bought in at 80 cents, and wants to vote down the latest amendment? These situations makes for very strange bedfellows.

The lack of regulation allows hedge funds to advance funds into a troubled situation in order to avoid a default. One agent told us that a hedge fund advanced funds to a troubled borrower through a side agreement so that the borrower wouldn’t trip a covenant, over the objections of the lender group. This allowed management to continue doing what they were doing, even though they were simply adjusting the angle of the aircraft as it plummeted into the ground.

We hear of other situations where the company hits an air-pocket, and the private equity group offers to buy the senior lenders out at 25 cents on the dollar. The resulting heartburn from this type of move by the private equity group slows the decision-making process down in the senior lender group. An unsettling thought for some alternative finance lenders is private equity groups buying up the senior debt of a portfolio company at a discount, then putting the squeeze on the second lien, subordinated debt, and mezzanine layers.

The immediate response that comes to mind is equitable subordination—the private equity group’s piece of debt becomes equity. However, there are instances in the marketplace where private equity groups have set up special-purpose entities which are 49% owned by the private equity groups. This structure is intended to avoid cancellation of debt tax issues, but also may avoid equitable subordination issues. This issue may only be decided in the courts, but the threat of it has unsettled some lenders who are sandwiched between senior debt and equity.

Now, some senior lenders are specifying tight anti-assignment language in loan agreements, so that the company’s ability to swap out stringent lenders for more compliant lenders is blocked. However, this type of restriction was absent in most legacy deals.
A principal concern is that many inter-creditor agreements are untested, and the outcomes will only be decided in a court of law. Again, this keeps lenders up at night because of the inherent unpredictability of some judges. And there are some situations where lenders are hiring their own individual legal counsel. The potential waste of time and money is very clear.

In the days of simpler capital structures, the entrance of distressed players into the fulcrum security historically would accelerate a transaction, because the distressed investors often would buy in at a sufficiently low price that they would be willing to trigger a crystallization at a 20%–30% return on that purchase price. The advent of multiple layers to the capital structure blurs the clarity as to which security is truly the fulcrum security and may make negotiation more difficult. This is especially true if some of the investors bought in at prices above that which the distressed players are willing to accept. Compounding matters is proliferation of second-lien paper, which in some instances may restrict the ability of a company to secure debtor in possession (DIP) financing, or set the stage for a priming fight.

ZOMBIE SYNDICATES

Some borrowers may take advantage of this situation, with the result that a deal becomes a zombie. We have seen situations where the participants in the capital structure are duking it out, while management tries to play off one side against the other. Or there are those instances where management gets so distracted trying to please each participant in the capital structure that they take their eye off the ball from a day-to-day management perspective. Or they become a deer in the headlights, unable to make decisions with business risk because they are afraid of displeasing the party that ultimately gains control.

In many underperforming companies, the incumbent management does not fully appreciate how quickly the downward spiral can accelerate. Consequently, they are less likely to take the drastic steps needed to salvage the company. Once they are behind the curve in cost cuts, it can be difficult to regain control of the situation. Yet a complex capital structure can muddy the waters to the point where management becomes ineffective.

DIP FINANCING: DON’T BANK ON IT

There is very little DIP financing available in the marketplace these days. This is in stark contrast to the last recession in 2001–2002. According to industry players, there are only one traditional commercial finance firm, some Canadian banks, and a handful of hedge funds that are actively soliciting new DIP business. Traditional ABL shops still want to do the triptych of bankruptcy financing—the pre-filing financing, the DIP, and the exit financing with existing borrowers—but they are not going out of their way to look for new DIP financing opportunities.

Despite a jump in bankruptcy filings last year, new DIP loans were sharply lower in 2008 than in the two most recent bankruptcy waves, according to data from Thomson Reuters. In 2008, the number of new DIP loans was about 35% below the number issued during the economic downturn in 2002, and about 46% below the number issued in 2005 ahead of changes to the bankruptcy code. The data showed lenders are still doing “defensive DIPs,” or “DIPs of necessity,” but they’re often very short term with restrictions or demands for a quick auction process. The lender’s incentive isn’t to rehabilitate companies, but rather to keep the company afloat long enough to find a buyer.

Interest rates for DIPs have spiked in recent months, more than doubling from a year ago. The average DIP loan in 2006 and 2007 was LIBOR plus about 4% to 4.5%. Last year, it jumped to LIBOR plus 6.1%, but rose higher throughout the year. In January 2009, chemicals maker LyondellBasell, which filed for Chapter 11 protection, paid LIBOR plus 10% for its term loan.

Players willing to do a DIP are able to charge hefty fees and rates simply because of the scarcity factor. Also, many hedge funds want call protection of two to three years in today’s marketplace, and consequently are shying away from DIPs because there is no real call protection. Some industry observers foresee more priming fights in the years ahead because of the aggressiveness of some hedge funds, but others think that the courts really don’t want to see an incumbent get primed. Certainly, threats will be made about priming fights, but the courts will be unlikely to grant them.

Compounding this problem, once a company is in Chapter 11, a capital structure that looks like a wedding cake may make it tough to facilitate a 363 sale. How do you allocate proceeds from a sale between the
PUTTING MAKE-UP ON A CORPSE

A growing number of struggling companies are choosing to liquidate in Chapter 7 rather than try to restructure in bankruptcy court. Many companies are caught between a slowing economy, a lack of bankruptcy financing options due to industry consolidation and the credit crunch, and the legacy covenant-lite lending agreements that allowed their financial situations to worsen before creditors could intervene.

This lack of covenants has raised the fear that companies will deteriorate to the point of no return while the lenders look on in horror. For example, the historically low interest rates have enabled many borrowers to have mediocre performance but make their interest covenant with ease. We saw one situation where the lack of covenants allowed a $1.1 billion company to operate on daily availability of $1 million. This company had suffered an erosion of EBITDA from $80 million to $2 million, and the lender group had limited power due to the covenant-lite structure of its loan.

In the collapse of Bennigan’s and Steak and Ale, the company bypassed Chapter 11 altogether. After filing for Chapter 7 bankruptcy, the parent company of these national chains immediately closed 200 restaurants. According to The Wall Street Journal, the liquidation filing represented one of the largest Chapter 7 bankruptcies of a restaurant chain in recent history, and was the most extreme example yet of how mid-price, sit-down restaurants are experiencing one of their worst periods in decades. The chains had been in negotiations with lenders since last year to stave off a filing, while closing 75 restaurants and looking for a buyer. The abrupt shutdown caught employees and customers by surprise; on a Monday, managers at Bennigans and Steak and Ale were called or emailed and told not to open restaurants on Tuesday morning. Employees were told there wouldn’t be enough money to pay them for the rest of the week, according to The Wall Street Journal.

Indeed, some lenders are worried that some companies will go straight from the line lending groups into liquidation, forestalling the involvement of the workout group of a bank until it is “dead-on-arrival.” Usually, the tripping of a covenant allows the lender to request that a turnaround firm be hired by the company. Most lenders agree with the idea that getting a turnaround firm into a borrower as early as possible is a good idea. The turnaround firm can translate the story of the borrower into language that the lender can understand and gives the lender something to work with. But it’s hard for a turnaround firm to do much with a company that’s been toe-tagged.

LOOKING AHEAD

One of the factors that caught many people off guard was that in the cycle, the deterioration in the credit and equity markets preceded the deterioration in the economy as opposed to the other way around. Typically, the economy shows signs of weakness, which then triggers a downturn in bond and stock markets.

Indeed, with lenders fearful of surging defaults in commercial loans in 2009, the workout departments are building bench-strength in a hurry. Defaults are predicted to double in 2009. Through March 2009, there have been 46 Chapter 11 or Chapter 7 bankruptcy filings in 2009 by public companies with total combined assets of $74 billion, a total nearly seven times greater than the $11 billion in assets of the 21 companies that had filed by this date last year. April 2009 is nearly $60 billion ahead of the high water mark in bankruptcies in April 2002. Until 2008, underperforming loans could be sold or refinanced with comparative ease. Today, lenders have to work out problem loans. Lenders are fearing a prolonged, L-shaped recession because of the steady drumbeat of bad headlines—plunging auto sales, record job losses, a dismal 2008 Christmas season for retailers, overleveraged companies sinking beneath the waves, and the “F” word—fraud.

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What Public Companies Can Learn from Private Equity: 
Pursue the Value Journey

WILLIAM J. HASS AND SHEPHERD G. PRYOR IV

OUR GOAL IS TO TRIPLE YOUR INVESTMENT IN ABOUT FIVE YEARS AND WE HAVE A TRACK RECORD TO PROVE IT!”

Those remarks wrapped up the presentation by the general partner of an established private equity firm to a pension fund manager. As we all know, that return goal is much higher than anyone would expect from the S&P 500. The leaders at most public companies are more than reluctant to commit to deliver comparable returns to their shareholders. In addition, most public companies remain focused on accounting results, rather than any form of shareholder value metrics.

START WITH DISCIPLINED, AGGRESSIVE GOALS

Private equity fund managers generally set the priority goal to manage for value. Successful ones pursue the goal of producing annual returns over 20% to 30%, with discipline and speed. Additionally, private equity leaders master the detail of generally accepted accounting principles (GAAP) and understand their proper use and deficiencies. They have their own proven valuation frameworks and employ greater discipline in building value. Because private equity investors have more frequent and action-oriented communication with their portfolio companies, they develop and employ more realistic assumptions about the future than their public peers.

Private equity leaders typically have a strong focus on capital allocation based on the relative cash flows generated by the businesses in which they invest. They drive the awareness that there is a cost of capital down to the front line worker level. See Exhibit 1.1

Professional money managers and business executives are generally sophisticated enough to understand the basics of discounted cash flow (DCF) models. Unfortunately, too many management teams of public companies remain wedded to simplistic valuation multiples of EPS. There they stay, until the difference between their stock price and their multiple-based expectations forces them to reformulate. At best, accounting multiples represent a starting benchmark for value builders.

Consider this comment from the former president of Hertz (while it was a subsidiary of Ford), after the private equity buyout: Ford used financial benchmarks like EBITDA and cash flow before the private equity buyout but those practices under private equity ownership “have been expanded broadly.”

Corporate insiders and outside investors and analysts value companies differently. Corporate leaders generally try to build value, but their incentives may be wrongly focused on value drivers that have only a weak link to corporate value (e.g., revenue and GAAP earnings per share (EPS)). In public companies, the link between incentives and corporate value becomes even more remote.
It is rare to find the head of a public-company business unit who has any real sense of ownership of the performance and the intrinsic value of his business unit.

The way any company approaches value building is of great interest to its owners. There is a growing body of knowledge indicating that personal biases and hopes influence their perception of value. Since analysts and managers are all wired differently, it is not surprising that we all have different views on valuation and how the world actually works. People make their own decisions, and often defy the logic of the best economic model. However, value is not a “matter of opinion.” The range of values results from the different ways in which cash flows are projected and corporate value is estimated. The final truth is in the cash that is ultimately generated and returned to the investors.

We have all heard, “What gets measured gets managed.” Yet debate on what should be measured and managed continues. Different groups have been grabbing for the steering wheel on this subject for decades. Regulators, accounting authorities, boards of directors, and management all have influence, and each has a different stake in the methods used. Investors have been left to pick through the disclosure documents, looking for the important facts. Legal and regulatory pressures have imposed GAAP as the communicating framework of choice. Unfortunately, investors find GAAP poorly suited for describing the real economics of a business. For estimating intrinsic value, GAAP only provides a starting point, and a distorted one at that.

Some more enlightened corporate leaders and most private equity investors go beyond GAAP, using non-GAAP measures and forecasts of future cash flow to provide a better link to value. While public companies are dissuaded from giving forecasts, private equity-owned portfolio companies routinely provide cash budgets and forecasts to their owners.

At the bottom line, private equity investors and better business managers dig deeply into the drivers of future cash flows and value. They allocate limited capital based on DCF, tying their goals and actions to corporate value. Having a scorecard based on value helps. Most private equity players closely track the value of their portfolio companies. Those public companies that report with value-based scorecards demonstrate to investors that they also track value. Beware of those with no value-based scorecard.

**IMPROVE DISCLOSURES: TELL OWNERS ABOUT THE BUSINESS**

Top private equity investors require frequent communication on cash flow and value from their portfolio companies. While public companies do have some limitations and restrictions on disclosure, they are protected by safe harbor rules. Think about the broad differences in how public companies disclose financial performance. A review of the annual report of a public company can begin to shed light on how top management and the people on the factory floor view the importance of corporate value.

Investors in public companies may find important insights on management’s commitment to value building in SEC filings, as well as through the tone and facts disclosed in analyst presentations. A determining issue is transparency. Investors want to see the underlying “truth” about the outlook for companies they invest in. That truth
is frequently obscured by masses of detailed data. Investors want to know management’s goals. They want to know what’s working and what’s not working relative to those goals. Private equity investors are not limited by GAAP or restrictions on communication with management. They want to understand cash flow and value drivers.

Private equity is in a better position to develop a transparent view into the workings of its portfolio companies, but public company managers can bridge the gap and provide similarly useful information to their investors.

**SET GOALS FOR SBUs, WHERE THE PERFORMANCE ACTUALLY HAPPENS**

Frameworks like the value waterfall in Exhibit 2 help management and investors understand which business units, products, or customers are contributing to value and which are destroying value. The value waterfall can be applied to any company or within strategic business units to understand which product lines and which customers allow the company to earn its cost of capital. Companies want to provide value for the customers, but customers need to be willing to pay enough for the company to make a reasonable return.

John Deere and Best Buy distinguish themselves through their value-based disclosures and management’s commitment to extend the reach of value-based thinking to front-line employees.

Deere shows us that a public company can disclose value metrics and goals by key business line. For years, John Deere has published operating return on assets and shareholder value-added (SVA) metrics for each of its

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**EXHIBIT 2**

The Value Waterfall Demonstrates a Commitment to Value Building

Notes: Segments 1–3 add to corporate value, but 4–6 decrease overall value. Valuation accuracy is consistent with the company’s ability to perform analysis. Sale or restructure of Segments 4, 5, and 6 should be considered.

key lines of business. Because these are “non-GAAP” measures, additional steps are required in the public reporting. Going the extra mile and disclosing these value-based metrics in good years and bad says a great deal about Deere’s commitment to a value-creating culture. Management adds the finishing touch by linking incentive compensation to some of the same key metrics.

Best Buy has consistently included in its annual report a return on invested capital (ROIC) calculation. Management also educates front-line store employees as to how they can improve ROIC for their store and department. Simply disclosing ROIC trends and helping all employees understand the importance of creating a return above the cost of capital is one of many reasons Best Buy has outperformed its peers. Hedge fund legend Ed Lampert, chairman of Sears Holding, has struggled for years to get Sears to focus on value. In his February 26, 2009, letter to shareholders, he outlined his value-rebuilding strategy in the face of a global financial crisis.4 Lampert has divided the company into strategic business units and disclosed his goal to close stores and businesses that are not likely to earn their cost of capital. He has challenged senior management to change the culture of the company to build better brands, improve merchandising, and create relationships with customers, in an effort to create value for the owners. Sears, like many public companies, is in the first stage of the value journey.

**EXHIBIT 3**

**Public Disclosures Signal Commitment to Value**

<table>
<thead>
<tr>
<th>Company</th>
<th>GOOD Value Disclosure</th>
<th>BETTER Value Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Berkshire Hathaway</td>
<td>Net Asset Value, described as a weak surrogate for intrinsic value</td>
<td>Buffet comments on the value drivers of Berkshire’s four business segments</td>
</tr>
<tr>
<td>Best Buy</td>
<td>ROIC and its computation in an easy to understand full page</td>
<td>Economic Return on Capital</td>
</tr>
<tr>
<td>Briggs &amp; Stratton</td>
<td></td>
<td>Economic Profit, Total Shareholder Return</td>
</tr>
<tr>
<td>Corn Products</td>
<td>ROCE, Market Capitalization, Debt to Capitalization</td>
<td></td>
</tr>
<tr>
<td>Chevron</td>
<td>Cash Dividends, ROCE, and Debt to Enterprise Value</td>
<td></td>
</tr>
<tr>
<td>Clorox</td>
<td>Free Cash Flow</td>
<td></td>
</tr>
<tr>
<td>Hewitt Packard</td>
<td>Cash Flow From Operations and Free Cash Flow</td>
<td></td>
</tr>
<tr>
<td>General Electric</td>
<td>Model one-page scorecard with multiple trends</td>
<td>Total Shareholder Return</td>
</tr>
<tr>
<td>Manitowoc</td>
<td></td>
<td>EVA and market value tracked over several years</td>
</tr>
<tr>
<td>Temple Inland</td>
<td>ROI by sector</td>
<td>Commitment to better ROI first and growth second</td>
</tr>
<tr>
<td>Whole Foods</td>
<td></td>
<td>EVA as a tool for major decisions and incentives for 750 managers</td>
</tr>
</tbody>
</table>
A growing number of public companies are showing more value metrics and talking intrinsic value in their published reports. Exhibit 3 contains a listing of companies that go far beyond the confines of GAAP to disclose better measures of value. These companies show a commitment to value, and their disclosures are more than one-liners.

Unfortunately, the full list of public companies dedicated to value-building is far exceeded by those that stop with the required GAAP disclosures. Note that companies that reduce their annual report to a cover sheet over a 10-K report can still add valuable content on the few added pages. Doing so speaks volumes about a company’s track record and commitment to value creation.

A final example is that of American Capital, a public company that operates with a private equity model. In its 2007 annual report, the company includes trend charts of such value-based metrics as:

- Net asset value per share.
- Internal rate of return on investment pools.
- Cash dividend levels and increases relative to LIBOR.

In contrast with reports like those of Deere and Best Buy, most public company reports display only GAAP or “EPS-speak” metrics. Examples of this are found in the annual reports of Hospira, a 2004 spinoff of Abbott Labs, and Kodak.

Hospira’s 2007 annual report contains an imprecise statement about its commitment to giving stockholders a “fair return” and to safeguarding their investment. While it points to its two key strategies, “investing for growth and improving margins and cash flow,” these goals are not quantified, leaving investors in the dark. The SEC-mandated, five-year corporate performance graph shows Hospira outperforming the S&P500 Index and S&P Health Care Index for the period 2004 to 2007, but the company does not state any goal to achieve that degree of relative performance going forward.

Kodak, once the leader in its industry, provided little more than a 10-K form for its annual report in 2007. For a company that dominated the image industry, Kodak’s value-based disclosures are woefully lacking. Any disclosure techniques or commitment to value by Kodak’s management is left unstated in its major annual communication to stockholders.

**MANAGE THE PORTFOLIO:**
**SET GOALS TO GROW, FIX, OR SELL**

Formerly successful business units and public companies can lose their way. Served markets change. Value builders find it more difficult to create value in depressed or highly competitive markets. Private equity and public companies react differently to the need to respond to external changes. While private equity normally plans to hold the companies in their portfolio for three to eight years and then realize their gains, public companies can be loath to sell business units, considering it a sign of failure. This can be a big handicap for public companies with underperforming business units.

General Motors was once the gold standard of the modern corporation. Alfred P. Sloan, president and chairman of GM from 1923 to 1956, challenged each operating division to earn a return above its cost of capital. However, this crucial goal and the managerial discipline that it fostered got lost in the scramble to cut costs. Underperforming divisions lived on, long after they should have been axed. The business had changed due to competition, but leadership was not able to make the changes necessary to maintain an adequate return.

Private equity is far less patient. Because their primary motivation is corporate value, they rarely bog down in deciding whether to close down a losing portfolio company that is bleeding cash. Unburdened by considerations about public reporting, they typically say “no” to funding a losing portfolio company that has dim prospects. Equipped with a clear vision of the returns they expected when they bought the company, private equity players are in a position to detect failure earlier. Successful ones go so far as to build in contingency plans to liquidate or divest early enough to protect the original investment. Occasionally a private equity fund will be hit by a disaster that arises with such speed it overwhelms the early warning systems and built-in protections. However, private equity has notably quicker survival reflexes compared with typical public companies.

Public companies can become preoccupied with the noise of quarterly reporting, expending much more of their intellectual capital on reporting, to the detriment of analyzing and repairing the problems that constantly challenge them. Private equity investors are generally better at raising the “signal to noise” ratio, because they are able to devote proportionally more time digging into the value equation. This puts them in a better position to respond to external threats and changes in the competitive environment.

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TOP VALUE BUILDERS HAVE A VALUE-BASED SCORECARD

Value building requires going beyond the GAAP metrics found in multiple databases. It requires digging into the CEO's brain through the tone of the annual report and compensation plans. Consider the following questions for any outside analyst or corporate director to ask when refining assumptions about a company and its future performance:

1. Does management have a disciplined value-building strategy and scorecard?
2. Is the scorecard prominently displayed with trends?
3. Is the scorecard oriented toward value-building or GAAP?
4. Does the executive compensation program support the scorecard and value?
5. Is the need to earn more than the cost of capital accepted by all employees?
6. Is the scorecard linked to a robust market based valuation framework?

In our analysis, private equity investors pursue value as an overarching goal. As a result, value metrics are more consistently and concisely incorporated into compensation and governance practices.

USE VALUE-BASED INCENTIVES TO ACHIEVE GREATER VALUE

A well-drafted annual report can help to underscore management's commitment to value and also to communicate a consistent message of value to employees and stockholders. The disclosures that are the most meaningful to investors in this area are those that management volunteers. When the disclosures are limited to those mandated by the SEC, they may lose value as they become matters of form.

Since early 2007, proxy statements from public companies have been required to provide more complete disclosures of total executive compensation than ever before. This is an area of reporting where there have been few volunteers. In this case, the SEC is forcing companies to quantify components of executive compensation that have been hidden from view in the past. Investors should now be able to determine whether top management is being "paid for failure." Investors should also be able to compare the compensation of top executives in comparable companies. These new disclosures now run from five to eight pages or more.

Because private equity firms buy businesses with the goal of creating value within a short time period of three to eight years, they focus management incentives on the same goals. In contrast, public companies see their various business units as permanent parts of the overall enterprise. This creates an important distinction, as public companies find it difficult to develop the same visibility as private equity concerning management's actual ability to create value. Nothing clears the slate like the sale of a business unit. With cash in hand and the sale of a business, management's success or failure is abundantly clear. Unfortunately, there are still significant business units within public companies that have no income statements and balance sheets. Without these basic tools of measurement, the value created or destroyed by the performance of a business unit is nearly impossible to determine.

Regardless of the managerial capability of the company, it still must make its executive compensation decisions. All boards find compensation discussions difficult. The goal is to establish a disciplined value-building culture, supported by consistent compensation incentives. Unfortunately, the cultures of many companies are heavily focused on product lines or customers, to the detriment of shareholder value. For example, the U.S. auto executives fell in love with their products and got caught up in political disputes with labor. Compensation at all levels, throughout the industry, drifted away from creating shareholder value. Management forgot about convincing the employees that the company had to produce a rate of return above the cost of capital for their shareholders.

When a private equity firm buys a sleepy and undervalued company or division, it installs management incentives to build value. These incentives promote change to a culture that makes everyone accept that the business exists to produce a return on capital for its shareholders. Original management teams that do not understand the new value-creating culture are quickly exposed and asked to leave.

Most private equity buyouts install a higher level of financial discipline than that found in the average public company. Exceptions are public companies that were leveraged buyouts. For example, Borg Warner's CEO, Tim Manganello, commented in his 2005 annual letter to shareholders: "Ours is a culture of: entrepreneurial innovation . . . ,
Bob Lane at Deere has proven to us that public companies can be effective at setting incentives consistent with shareholder value. Before Lane became CEO of Deere in 2001, most employees at Deere had little idea of the importance of earning a reasonable return. The movement of Deere’s stock price with the business cycle had been a constant source of pain, with compensation periodically whipsawed by external events. At that time, Deere was considered by many investors to be a “good” company, but it remained victimized by the strong economic cycle of farm and construction equipment and a unionized work force. Lane explained to employees that they had great products, but not a great business. He initiated a culture change program to make every employee aware that there was work to do to make Deere’s business as great as its products.

Educating employees on value and economics was a top priority for Lane. The consistent theme of the annual report over the next six years was easy for employees and investors to understand: “Growing a business as great as our products.” Compensation goals were based on increasing shareholder value. This meant earning a realistic minimum target return on capital, taking into account the reality of the business cycle. During the upward phase of the cycle, the return goal was set at 28%, at mid-cycle 20%, and in decline 12%. Every product team at Deere must have a plan in place to achieve these goals as part of its short-term incentive program. The use of the different goals for different stages of the macroeconomic environment has allowed Deere to achieve higher levels of return at each stage of the cycle because it reflects the reality of the business.

Lane charged each business unit and division with an imperfect but meaningful 1% per month for capital employed in the business. Simple in concept, the 12%-per-year charge was not simplistic. It taught the entire organization that achieving an economic profit required covering the cost of capital. According to Bob Lane in a discussion with the authors on December 18, 2007, “the concept of economic profit and how it is applied is understood by thousands of managers, not by a few financial people at the top.”

In its annual reports, Deere educates investors and employees about the operating return on assets (OROA) of its key product lines. Management communicates with Wall Street analysts with value-based concepts like shareholder value added (SVA). At Deere, absolute gains in economic profit serve as the basis for medium-term incentive bonuses. To avoid bonus boom and bust, the bonus payouts are based on a four-year moving average. Deere’s long-term incentive program ties the fortunes of management to Deere’s success by requiring that the top 1,000 employees own equity.

Bob Lane considers value-based metrics like SVA to be more effective for its scoreboard. The SVA scoreboard has helped change the focus of Deere’s corporate culture from GAAP and products to value creation. Without value-based metrics it is hard to get people to think about the importance of cash flow and the effective use of capital. Compensation experts agree. Mark Ubelhart of Hewitt Associates believes that the value-based movement, which was so visible in the 1980s and 1990s, has had a significant and lasting impact on the design of compensation plans. Research shows that more companies are using disciplined value based metrics like cash flow and ROIC in their plans.

Don Delves, president of The Delves Group, has recently seen public company board compensation committees developing incentives for incoming CEOs with the goal of doubling the value of the company over a certain time period. He also notes that the depressed public company stock prices of 2008 and 2009 are putting most stock options out of the money. While CEOs of private equity portfolio companies look to exit value, those rewards are also pushed further into the future. More companies are putting more incentives on operating cash flow and market share gains as stock prices are highly uncertain during the current economic crisis. In the uncertain economic environment of 2009, some public companies are setting lower incentive goals and lower payouts intended to cover a wider range of outcomes.

**Better Governance Takes Time, Manageable Size, and Skin in the Game**

Directors of the portfolio companies of more successful private equity funds spend more time to get better insights. According to one study, non-executive directors of private equity-backed companies “spend on average, nearly three times as many days on their roles as do those at public companies (54 versus 19).” They focus on the performance of key people, cash flow, and the value-drivers of the business units more so than their public
peers. Due to time demands, public directors find it difficult to get more involved. One alternative is for public company directors to engage a dedicated board analyst or value consultant to help them understand performance of the company down to the business unit level.

According to Ray Svider, a managing partner of private equity investor BC Partners, 10 boards of public companies must overcome agency problems to improve the value-creation practices of public companies. While they may rely on compensation consultants to help design compensation plans, the directors of public companies don’t have time to devote to really understanding the industry issues in depth. Thus they have difficulty assessing management and value performance. Svider related his experience as a director on one board, where he continued to serve for 10 years after his private equity fund took the business public in an IPO. Even 10 years after the IPO, he was still looked to as “the board expert” on company issues. This was the result of the three-month due diligence process he led when his private equity fund made the initial investment in the company, and his close monitoring of the company while it was owned by his private equity fund.

According to Svider, the other directors never took the time to understand the issues facing the company because of their other “full-time” duties as seated CEOs of their own companies. Public company directors are more likely to accept the recommendations of management rather than challenge them or replace managers for underperformance. Replacing a public company CEO takes a great deal of time for even a subcommittee of the board. Public company boards are therefore more likely to tolerate sub-potential value-building performance, relative to their private equity peers, who have skin in the game.

**SUMMARY: VALUE BUILDERS PURSUE THE FOUR STEPS OF THE VALUE JOURNEY WITH DISCIPLINE**

To successfully pursue the value journey to top-value-builder status, public directors and private equity investors must monitor progress along four major steps. Outside investors and analysts can evaluate public-company management on their progress toward top-value-builder status. Private equity-owned companies can generally move faster than their public peers. There are many small steps within each of the four basic steps described below:

1. Talk and think value. Engage in constant communication to the work force and full disclosure to the shareholders.
   a. Set the right value based goals.
   b. Communicate verbally and in annual and periodic reports to change the culture and ensure all employees understand how to build value.

2. Implement metrics to drive cash flow. These include return on invested capital, customer retention, customer value, and growth. Analyze served market size, growth and market share trends.
a. Provide incentives based on value-based metrics.
b. Go beyond simplistic EPS-speak metrics to a value-based scorecard.
c. Understand the portfolio and waterfall of values: SBU, product, and customer.

3. Report and act on value insights and value-driver trends. Disclose performance of key parts of the portfolio on a regular basis, not just if the trend is positive.
   a. Report on value-based trends monthly at the operational level and at least quarterly to the board. Monitor changes in the value waterfall.
   b. Develop plans and scenarios that explain potential results and risks, as well as how better results will be achieved and risks mitigated.
   c. Execute plans to improve portfolio value, reduce risk and cut losses.

4. Push toward the goal of achieving top-value-builder status with total shareholder returns of 20% or more.
   a. Recognize that most public companies will not earn 20% returns if they serve the wrong markets with the wrong products, particularly if they are guided by leaders who are not good communicators and value builders.
   b. Once 20% returns are achieved, ask how long they are possible in the face of competition.
   c. Understand market values relative to intrinsic value, and when to buy and when to sell.

ENDNOTES

We owe a debt of gratitude to several people who assisted in the adaptation of this article by reviewing and providing insights, including Edwin Marks, Sean Falmer, Rawley Thomas, Robert Agnew, Duncon Bourne, and others.

This article is adapted from three sources:


Go to www.topvaluebuilders.com for links to related topics.


Co-author interviews with Don Delves, president, The Delves Group, March 4 and 10, 2009.


Ray Svider, managing partner, BC Partners, panelist, Private Equity Conference, sponsored by the University of Chicago Booth School of Business, Chicago, February 20, 2009.


To order reprints of this article, please contact Dewey Palmieri at dpalmieri@iijournals.com or 212-224-3675.
Liberating a Business from Its History: The Turnaround of Dana Corporation

CORINNE BALL, HENRY MILLER, AND TED STENGER

When Dana Corporation’s executives called Corinne Ball of law firm Jones Day to Dana’s Toledo, Ohio, headquarters in mid-February 2006, Dana’s situation was rapidly evolving from contingency planning to liquidity shortfall. Ted Stenger of business advisory and turnaround firm AlixPartners had arrived barely days earlier to focus on a proposed refinancing. Henry Miller of investment bank Miller Buckfire would arrive within 48 hours. Dana was operating on waivers from its lenders, enabling it to complete a restatement of prior years’ financial statements. Dana operated in 28 countries, had roughly 40,000 employees—many of them unionized—and had a complex capital structure.

Even prior to engaging restructuring experts, Dana had been working to upsize its credit facility and dispose of some operating subsidiaries to meet anticipated liquidity needs. A recent highly publicized earnings restatement, as well as the attempted refinancing of its credit facility, may have served as a catalyst to review Dana’s liquidity position and near-term business plan, but numerous other hurdles blocked Dana’s path to profitability:

- Upcoming principal and interest payments;
- Unprofitable supply contracts with its original equipment manufacturer (OEM) customers;
- Escalating material costs;
- A complex matrix of cross defaults;
- An inability to repatriate cash trapped in Europe;
- The magnitude of legacy benefits burdens retained after the sales of several business units in a disposition program; and
- A shrinking revenue base.

All these factors forced Dana to reassess its financing needs, its debt capacity, and its competitive position in the industry.

As Dana assembled its turnaround team, it was relatively clear that, absent a successful and nearly immediate refinancing, Dana would run out of cash in a matter of weeks. Miller Buckfire worked the capital markets, and AlixPartners provided the business plan analysis for purposes of the refinancing. Any attempted rescue financing was going to be difficult at best. Before long, with the addition of AlixPartners Managing Director Ken Hiltz as Dana’s new CFO, Dana faced a choice—continue with the rescue financing, pledging all of its assets and operating under a business plan that used much of the financing capacity for debt service and legacy support, or convert the rescue financing into a debtor-in-possession, or DIP financing, to provide...
liquidity for operations and the time for Dana to reorganize under Chapter 11 of the Bankruptcy Code.

Twenty-one days after the start of Dana’s contingency planning, Dana commenced its Chapter 11 cases in the Southern District of New York as one of the first major industrial enterprises to be subject to the Bankruptcy Abuse and Consumer Protection Act of 2005 (BAPCPA), thereby being subject to the newly imposed 18-month time limit on a debtor’s exclusive right to file a plan of reorganization. Against all odds, Dana filed its reorganization plan days before this deadline was set to expire, obtained overwhelming approval of the plan approximately 90 days thereafter, and ultimately consummated its plan of reorganization on January 31, 2008. In contrast, others in the automobile industry, such as Delphi, continued to languish in bankruptcy despite entering years earlier.

Prior to confirming its Chapter 11 plan and within the strictures of the new BAPCPA deadlines, Dana completed:

- The out-of-court restructuring of the $500 million in debt owed by its captive credit company;
- A complex U.K. restructuring, known as a Company Voluntary Arrangement (CVA), to address its U.K. legacy and pension obligations;
- A tax-efficient recapitalization of its European operations, enabling it to repatriate cash and raise capital through a pan-European facility;
- The sale of its non-core businesses; and
- Revamping its production process, including moves to, as well as new investments in, lower-cost countries.

Additionally, Dana initiated, litigated, and successfully resolved its union agreements and its legacy obligations, providing each of the United Automobile, Aerospace and Agricultural Implement Workers of America (UAW) and the United Steelworkers (USW) with a substantially funded voluntary employee benefit association (VEBA). Equally important, based on the success of the other restructuring initiatives, Dana was able to attract and obtain commitments for almost $1 billion in new equity investment and $2 billion in exit financing. Given its determination to accomplish fundamental change in this compressed time period, Dana emerged relatively unscathed. By not squandering its time or resources on litigation related to its bankruptcy filing, except for the controversy over legacy labor contracts and a pioneering approach to executive compensation, Dana successfully avoided most battles. This allowed the primary focus to be on formulating and implementing its operational and financial restructuring initiatives, ultimately allowing Dana to exit expeditiously from Chapter 11.

New challenges await Dana in a troubled automobile sector facing a frigid retail market for its goods, but it stands in a better position than many of its peers to weather the storm and emerge as a viable competitor when global economic conditions recover.

THE SITUATION

Dana Corporation is an automobile parts manufacturer founded more than 100 years ago that specializes in the design and manufacture of axles, driveshafts, frames, and a number of other automotive products. In general, Dana sells component parts to automobile and heavy equipment OEMs, primarily the “Big Three” American automobile OEMs: General Motors, Ford, and Chrysler.

Prior to 2003, Dana had engaged in an aggressive campaign of expansion, generally through the acquisition of other manufacturers. Some of these acquisitions had proved successful; others had not and were sold in the years leading up to Dana’s Chapter 11 case. But this left Dana with a difficult-to-manage global operational footprint and a labyrinthine-like corporate structure that did not necessarily correspond to the actual relationship between various business units. Furthermore, Dana retained virtually all the legacy, environmental, and asbestos liabilities of the divested businesses. By early 2006, the proceeds from the divestitures were gone and Dana was overleveraged, overburdened, and cash-starved.

Meanwhile, the Big Three, Dana’s largest customers, continued to lose market share to their foreign counterparts and relied heavily on their capabilities in producing light trucks, including SUVs. In order to remain competitive in the traditional automotive market, the Big Three had negotiated price breaks with their suppliers, including Dana. As global demand pushed gasoline and other commodity prices higher, consumer demand in the light truck market plummeted, and the Big Three continued to lose market share in traditional automobile segments, such as mid-sized and compact sedans. Demand for Dana’s products dropped, and Dana was strangulated from both the supply and demand side;
costs of production were increasing while revenues from its core businesses were choked.

THE FIRST 21 DAYS—ASSESSING THE SITUATION

The decision-making process that led to the bankruptcy filing for the U.S. entities was driven by a looming liquidity crisis. But Chapter 11 presented its own challenges. Holding a global enterprise of Dana’s size together through a Chapter 11 case was a daunting enough challenge without the substantial added complication that Dana’s operations were globally integrated. Its production cycles spanned multiple countries. Additionally, it was entirely dependent on “just in time” inventory around the world, not just in the United States. Liquidity was the first driver of the decision, but survival of its global enterprise was a very close second. Dana had to enable every offshore affiliate to continue sourcing, and finishing production throughout the globe. Historically, Dana’s U.S. entities had acted as the borrower and funder of its global operations, and once Dana became a debtor-in-possession, the foreign operations would need assurance that they would have sufficient resources to operate and withstand a “cut-off” of funds from the U.S. entities. Any substantial break in the inter-company chains of production and supply would have crippled Dana’s restructuring.

This reality led to a series of first-day motions on cash management, inter-company payables, and affiliated critical vendors. Most importantly, Dana had to avoid any action that would destabilize the profitable European operations, panic their creditors or credit insurers, or lead to “rogue insolvency” filings abroad. Although Dana had substantial cash offshore in these European operations, the restructuring team believed that repatriation would be extremely destabilizing and pose tremendous risks. Instead the team recommended stabilizing the U.S. operations in Chapter 11 and concurrently reassuring the European entities that they had adequate cash and access to the DIP credit facility to maintain its operations uninterrupted, leaving repatriation and refinancing to a later date, after Dana was stabilized. Hence funding the European entities was a factor in sizing the DIP facility, which provided safety-net financing for the offshore subsidiaries while they accomplished their restructuring.

The third driver of the decision to utilize Chapter 11 was making sure that Dana continued to operate reliably and on time as part of the “just in time” inventory model that dominates the auto industry. If the disruption of filing forced Dana to shut down, it would disrupt the supply chain in the entire automotive sector, potentially causing shutdowns of suppliers and even possibly the Big Three. If this happened, Dana’s business relationships moving forward would be irrevocably damaged.

As the restructuring team analyzed ways to avoid harm and disruption in Europe, it became clear that the complex and fragile financial assets of Dana’s captive credit company, Dana Credit Corporation (DCC), coupled with its plethora of joint ventures and affiliates, would complicate the bankruptcy proceedings of this particular Dana subsidiary. Moreover, the restructuring team believed DCC, while an important part of Dana’s vertically integrated business, did not face the operational challenges that necessitated a bankruptcy filing. Thus, it was determined that the pursuit of a consensual restructuring with DCC’s bondholders was the appropriate mechanism to resolve this particular subsidiary’s financial difficulties. The Chapter 11 focus would be on Dana’s auto parts manufacturing business.

Surmounting these initial hurdles shaped the first-day planning. Meanwhile, there was a critical debate about what Dana should do as a debtor in possession: should Dana use Chapter 11 to effect fundamental change to attain long-term viability or should Dana pursue a quick case focused on converting its bond debt to equity and emerge as soon as possible. Some creditors thought Dana was merely experiencing an unexpected and resolvable cash crisis. Others reasoned that Dana was over-leveraged, had too many unprofitable OEM customer contracts, was not sufficiently redepolyed into lower-cost countries and was too burdened by its rich union and legacy operations, and thus, absent fundamental change, could not maintain a competitive presence in the automotive marketplace. In the end, by the time the March 1, 2006 bond interest payment was due, it was clear that Dana needed to file for bankruptcy protection. However, discerning the actions necessary for reorganization was still difficult, with bondholders favoring a quick balance sheet fix and the restructuring team favoring a full restructuring.

The team maintained a focus from the beginning on minimizing the bankruptcy filing’s impact on operations, and maintaining the integrated enterprise’s
stability, both in the United States and abroad. With this in mind, Miller Buckfire led the financing efforts, AlixPartners provided the operational review and coordinated the optimization of Dana’s capital structure and financial reporting systems, and Jones Day headed up the legal framework needed to synthesize all the efforts.

The team had limited time to:

- Secure a DIP loan to ensure sufficient global liquidity to operate during Chapter 11;
- Formulate a global cash treasury plan to give assurance of Dana’s continuing ability to operate to local management in foreign locations;
- Ensure that Dana would be able to timely ship to its customers and avoid forcing a customer to shut down operations;
- Prepare the filings needed for a “soft landing” in Chapter 11;
- Devise a means of speeding its redeployment into lower-cost countries;
- Preserve existing tax benefits;
- Recapitalize its global operations to permit the repatriation of cash and the raising of debt capital abroad;
- Address pension issues in the U.K. without threatening the continental European operations;
- Conserve its resources, restructuring over $500 million in debt in DCC outside of court; and
- Formulate a global communications plan to minimize the operational disruptions that often accompany a Chapter 11 filing.

If Miller Buckfire, AlixPartners, and Jones Day, together with management, were able to accomplish these goals, Dana would be well-equipped to stabilize its operations post-petition and accelerate into implementing restructuring initiatives and formulating its plan of reorganization. Focusing on these latter two goals immediately was especially necessary given the rigid 18-month exclusivity period imposed on Dana under BAPCPA. In addition, no major industrial had experienced the new vendor and reclamation provision enacted at the same time—a provision that gave vendors a voice early in the case and could potentially cause a new and significant cash drain. Dana also had to address the 210-day hard time limit on its decisions to assume or reject leases of real property. Given multi-plant operations across the globe, this new statutory deadline would place additional burdens on Dana in accomplishing its restructuring. Every move the team made in this time-compressed period would be precedent setting.

LOOKING PAST THE PETITION DATE

While 18 months may be sufficient for the vast majority of companies to formulate a plan and garner the support they need from creditors and other affected parties, companies the size of Dana have routinely remained under Chapter 11 protection for three years or more while market trends are examined and all sides negotiate the plan. Thus, the new time limit on the exclusivity period created a challenging situation for Dana and its advisors. Dana was by far the largest company to file for bankruptcy after the new provision was added to the Bankruptcy Code, and Dana’s restructuring would be the first real test of whether the limit was workable.

Dana had a dedicated professional team for the supply chain and was in court with suppliers early, succeeding in obtaining what has become precedent-setting injunctive relief on an expedited basis and sparingly using resources allocated to paying critical vendors. But Dana soon learned that a group of investors controlling a large amount of Dana’s bonds did not agree with management’s assessment that a full-scale restructuring was needed, but rather advocated a quick fix to the balance sheet through the conversion of Dana’s bond debt into equity. The impact on Dana became clear at the organizational meeting to form a Creditors’ Committee. Dana’s unions, the Pension Benefit Guaranty Corporation, the indenture trustee, many asbestos plaintiffs, and two vendors ultimately served on the Creditors’ Committee. However, only one bondholder agreed to serve. Because the unions and the PBGC were contingent creditors, and the indenture trustee was only an agent, Dana thus had a Creditors’ Committee with aggregate liquidated undisputed claims of a relatively de minimis $25 million. In stark contrast, Dana would soon have an Ad Hoc Bondholders Committee that, from time to time, claimed to represent almost 80% of Dana’s more than $1.5 billion in outstanding bond debt, generally insisted on being unrestricted and free to trade in Dana’s securities, and was far more concerned about the impact of Dana’s restructuring on the bonds’ trading price than about Dana’s long-term viability. Dana was also burdened by the appointment of an Equity Committee, due to a perception that Dana potentially was
solvent. Not surprisingly, the Equity Committee also advocated focusing on the balance sheet, as opposed to any restructuring of Dana’s business operations or legacy burdens.

**EVOLUTION OF THE STRATEGY—THE RESTRUCTURING INITIATIVES**

Turning to the more substantive restructuring issues, Dana and its advisors were able to formulate a broad reaching restructuring plan that included six key cost-saving components (see Exhibit 1):

1. Renegotiating contracts with customers, especially the Big Three.
2. Reformulating the wages and benefits of non-union employees.
3. Obtaining concessions from the unions, notably “true two-tier” wages, as well as relief from defined pension plans.
4. Eliminating obligations to retirees for “other” (i.e., non-pension) post-employment benefits (OPEB), especially retiree healthcare benefits.
5. Altering Dana’s operational footprint to optimize production in lower-cost countries and maintain its customers.
6. Reducing overhead costs.

**Contracts with Vendors and Customers**

The immediate concern after filing for bankruptcy was to stabilize the relationships with vendors and customers. Dana filed the appropriate motions with the bankruptcy court to give its vendors priority in payment during the pendency of the bankruptcy. This gave the vendors the necessary assurance that they would continue to be paid, and thus the vendors agreed to continue working with Dana.

With respect to Dana’s customers, it was clear that the price reductions implemented earlier had to be rolled back. Rather than reject its customer contracts under Section 365, as other suppliers had done, Dana undertook a massive and detailed review of all its customer contracts to work with each of them in the hopes of realigning contracts to reduce, if not eliminate, those that were unprofitable. While the restructuring team was very conscious of the need to achieve a competitive cost structure, they were just as concerned about driving revenues. Dana wanted to avoid litigation and reach a solution that was fair to its customers and assured them of a reliable source of product. Litigation, if things went badly, could have produced expensive and damaging work stoppages at Dana and its customers which would have caused Dana to lose cash quickly and do nothing but hurt its prospects for a successful reorganization. Thus, Dana, guided by AlixPartners, sat down with the customers early, simply pointing out that if price concessions were not eased, Dana could not continue to operate its business, and the OEM customers would need to find alternative suppliers of critical parts. The customers realized that they gained no advantage by incurring the costs to locate a new source for these parts, so consensual deals were struck, putting Dana on a much firmer financial footing in its operations. By modifying these contracts, Dana was able to achieve estimated cost savings of $180 million per year.

**Operational Footprint**

Dana and its advisors knew that the company would not survive if it could not streamline its operations. Dana’s management system was relatively decentralized, the various entities were geographically dispersed, and many of the operations were unrelated to Dana’s core axle and driveshaft manufacturing business. Thus, Dana
decided to divest its trailer axle business, engine products group, fluid products group, pump products business, and a minority equity interest in a German parts supplier. This would allow Dana to focus on its core business in the United States and a handful of profitable wholly-owned foreign subsidiaries. Between these modifications to Dana’s structure and the cost savings implemented through changes to the employee and retiree benefits mechanisms, Dana was able to achieve an estimated savings of $220–$245 million per year.

In addition, Dana continued the process of exiting the finance business. Dana had provided lease financing through a captive securitization subsidiary, DCC. Dana sold the leases to DCC, which was financed almost entirely by noteholders. DCC had begun in 2001 to sell off the leases and use the proceeds to settle with its noteholders, and by 2007 it had reduced its assets from over $2 billion to just $83 million. In order to avoid a potentially long and bruising fight with these investors, Dana used some of the proceeds from its DIP facility to purchase the remaining leases from DCC and settle with the remaining noteholders outside of court.

**Overhead Costs**

Finally, Dana was able to achieve significant savings through cost-cutting measures in engineering, sales, information technology, purchasing, accounting, and human resources. These overhead cost cuts would add up to approximately $40–$50 million per year. Collectively, Dana’s restructuring initiatives resulted in total estimated savings of $440–$475 million per year (see Exhibit 2).

**Employee Wages and Retiree Benefits**

Dana reviewed and revised the wages and benefits of all its non-union employees. For its active employees, Dana brought benefit levels, such as funding for healthcare, in line with those provided by its leaner and more profitable competitors. Dana implemented a 401(k) plan, including a matching program with merit increases, from profitable operations. Meanwhile, it discontinued life insurance, tuition reimbursement, and other benefits. But when it came to retiree healthcare and other legacy obligations owed to nonunion retirees, Dana still needed total relief.

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**EXHIBIT 2**

**Targeted and Realized Savings Resulting from Restructuring Initiatives**

<table>
<thead>
<tr>
<th>Initiative</th>
<th>Targeted Range</th>
<th>Likely</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customers</td>
<td>$175–225M</td>
<td>$180M</td>
</tr>
<tr>
<td>Employees/Retirees/Footprint</td>
<td>$190–265M</td>
<td>$220–245M</td>
</tr>
<tr>
<td>Overhead Costs</td>
<td>$40–50M</td>
<td>$40–50M</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$405–540M</strong></td>
<td><strong>$440–475M</strong></td>
</tr>
</tbody>
</table>

The first step to obtaining relief from non-union retiree liabilities was finding a representative to negotiate on the retirees’ behalf. The Bankruptcy Code provides for the appointment of a Retiree Committee as the representative authorized to negotiate for non-union retirees. Dana moved for the appointment of a Retiree Committee early on in its Chapter 11 case.

The restructuring team strongly believed that to be viable Dana required relief from its OPEB liability, especially healthcare, which was estimated to be approximately $1.5 billion, considering both past and present collective bargaining agreements (CBAs), as well as the many plans for non-union retirees. The restructuring team, however, did not subscribe to the Equity Committee view that such relief should be sought for the benefit of shareholders. Relief under these Sections required proof that, among other things, such relief treated all creditors “fairly and equitably” and relief from a CBA was “necessary to permit reorganization.” But obtaining such relief for the benefit of equity would be virtually unprecedented, if not beyond the scope of Sections 1113 and 1114. If Dana was found to be solvent, it was unlikely to achieve such relief. Jones Day would rely on the contributions of the other constituents under the restructuring initiatives in addressing the fair and equitable standards for obtaining statutory relief from the UAW and USW pursuant to Sections 1113 and 1114.

The legal team had been developing an alternative argument to rejection under Sections 1113 and 1114 through reviewing the hundreds of plans in place over the many years in which Dana’s retiree population had retired to determine whether Dana had retained a right to terminate retiree benefits. At first the Equity Committee would advocate this approach because it did not implicate Sections 1113 and 1114, but would instead be a motion under Section 363 for authority to terminate...
these plans unilaterally. When it came time to discuss this proposition with the UAW, the Equity Committee resigned.

Dana, however, chose to address its nonunion retirees under this theory and moved under Section 363 of the Bankruptcy Code to avoid payments to non-union retirees altogether, based on these contractual rights.

The hearings on the motions under Sections 1113, 1114, and 363 were scheduled simultaneously, and the Section 363 arguments were scheduled for the first day. The day before the hearing, fearing the total loss of benefits if the judge ruled against it on the first day, the Retiree Committee settled in exchange for approximately $79 million to fund a VEBA. Subsequently, Dana and the unions litigated the motions for relief from its CBAs under Sections 1113 and 1114. After the hearing, but before the judge issued an order, a deal was worked out whereby all OPEB costs were assumed by VEBA funded by Dana, for a grand total of approximately $766 million for all the CBA. Additionally, all current defined benefit pension plans were frozen, replaced by new defined contribution plans, and the unions allowed significant wage reductions to go forward.

**European Restructuring**

In addition to all of this, Dana effected a reorganization in the United Kingdom to resolve its U.K. pension and legacy obligations of more than $500 million through an independent plan funded by a dedication of approximately $93 million from Dana U.K. assets and a 33% interest in Dana’s remaining U.K. subsidiaries. Dana could then continue with the divestiture of its non-core businesses and protect its continental European operations.

Once the restructuring team was confident that Dana’s U.S. and European operations were sufficiently stabilized after the Chapter 11 filing, their attention turned to implementing the long-term strategic European restructuring goals. One such goal was the tax efficient repatriation of cash from the European entities. But because of various tax rules, a direct repatriation of this cash to fund the U.S. entities would entail significant tax payments becoming due. The team began searching for ways to allow the U.S. entities to take advantage of the cash without the immense tax liability. Eventually, they developed an innovative series of transactions that both restructured the European subsidiaries and brought the cash back into the United States. These transactions effectively exchanged Dana’s common equity interest in many of its subsidiaries for fixed-dividend preferred stock and debt in these same subsidiaries, which allowed for payments of cash from the European subsidiaries to Dana that were not subject to the onerous tax liabilities. Concomitant with the repatriation of Dana Europe’s cash, the restructuring team obtained a first-ever pan-European borrowing facility, enabling the European operations to be self-sufficient.

**PLAN SPONSORSHIP AND OBTAINING NEW INVESTMENT COMMITMENTS**

During the proceedings under Sections 1113 and 1114 to obtain relief from its CBAs and union-represented retirees, Dana was advised that Centerbridge Partners, a private equity firm whose founders had deep experience in distress investing and the automotive sector, had been retained to advise the UAW and the USW. In the negotiations related to the Sections 1113 and 1114 hearings, the union representatives took a strong interest in Dana's footprint studies, its proposal to freeze the union pensions, the OPEB/VEBA proposals, and the wage and work rule proposals. Dana and the unions had common ground: Dana’s achievement of sustainable viability and a strong competitive position upon emergence from Chapter 11 would benefit everyone. Reaching consensus on maintaining U.S. jobs at a cost-effective level was difficult, and the unions also had a commitment to their retirees. A VEBA was possible, but it would require a substantial cash contribution. As soon as the negotiations reached these serious issues, the unions urged Dana to consider a proposal from Centerbridge that it be the anchor for a large new capital investment in Dana. Dana advised Centerbridge and the unions that the bondholders were also interested in providing new capital.

After the union settlement, Dana soon moved toward negotiating its Chapter 11 plan and its exit financing. Dana needed financing for its post-bankruptcy operations and for the Chapter 11 plan, including a large cash payment into the VEBA.

Immediately after identifying and achieving the restructuring initiatives, the restructuring team began to focus on developing a business plan reflecting the impact of these initiatives. After this, Dana and its constituents could analyze its earning potential, debt capacity, and
had no time for a registered offering. Dana knew that exit financing would be conditioned on having the kets were rapidly eroding. In addition, Dana knew that a rights offering to thousands of creditors would emerge from Chapter 11 quickly. Dana did not believe that a rights offering to be offered to creditors), but Dana still needed preferred stock in a reorganized Dana (with a portion to the proposed investment, focusing on the level of participation offered to existing creditors.

As matters progressed, the restructuring team attempted to identify the best source of new equity capital and plan sponsorship for Dana. The timetable for obtaining capital was accelerated, but even then it had the potential to extend beyond the deadline for filing a plan. In the end, Dana used the momentum from the bidding process to solidify the desired compromise. Centerbridge’s offer to invest was supported by the bondholders. Throughout these negotiations, the Creditors’ Committee remained uncommitted with respect to the proposed investment, focusing on the level of participation offered to existing creditors.

Dana needed the $800 million in capital offered in the proposal, so the restructuring team focused not only on the terms, but also the certainty of closing and the amount of funds firmly committed. From the start, Centerbridge committed $500 million to purchasing preferred stock in a reorganized Dana (with a portion of that to be offered to creditors), but Dana still needed another $290 million. While Dana welcomed investor participation by its bondholders, it wanted assurance and commitments in order to obtain exit financing and emerge from Chapter 11 quickly. Dana did not believe that a rights offering to thousands of creditors would facilitate this outcome, particularly as the credit markets were rapidly eroding. In addition, Dana knew that any exit financing would be conditioned on having the equity funding prior to the plan’s consummation. Dana had no time for a registered offering.

Working with its bondholders and Creditors’ Committee, Dana adopted requirements for participation that allowed it to avoid SEC registration of the new securities: each potential investor needed to be a “qualified institutional buyer” for SEC purposes, and each investor had to hold at least $25 million in claims as of a prior record date. At the time Dana filed its plan and disclosure statement, it was still seeking a commitment for the final portion of the equity investment, but by identifying the major universe of potential investors through these criteria, Dana, Centerbridge, and the Ad Hoc Committee of Bondholders were able to formulate an initial allocation of governance rights, a projected investment return, consent rights, dividends, and other issues, and include them all in the plan.

Negotiations continued between Dana, Centerbridge, the Ad Hoc Committee of Bondholders, and the Creditors’ Committee, refining the criteria for participation by bondholders, including a payment to ineligible creditors in the plan and securing a backstop commitment from Dana’s largest bondholders for the remaining $290 million in equity necessary to fund the plan. With these commitments in hand, Dana pressed for a financing commitment to exit Chapter 11. But now the credit markets were in turmoil, and a committed exit facility was going to be more costly than Dana’s DIP facility. This raised the question of whether Dana should wait for the markets to calm before emerging from bankruptcy. After much debate, Dana determined that despite the cost, the certainty of a committed exit facility was necessary to assure emergence from Chapter 11 no later than January 31, 2008. Dana obtained the commitment and brought it to court just five days before commencement of the confirmation of its reorganization plan.

As Dana approached confirmation, the Creditors’ Committee challenged the private placement approach adopted by Dana in its reorganization. But recognizing the urgency in obtaining commitments quickly, the Bankruptcy Court upheld this unorthodox procedure.

**EPILOGUE**

In the end, Dana’s story is that of a remarkable turnaround in a short period of time, with a series of “firsts” in many areas. Dana was the first debtor to seek authority for unilateral termination of retiree benefits. Dana was the first Chapter 11 VEBA for the UAW.
Dana was the first multi-jurisdictional enterprise to accomplish a CVA in the U.K. while reorganizing under Chapter 11. Dana was one of the first pan-European financings achieved while in Chapter 11. Dana was the first to achieve a substantial restructuring of customer contracts without litigation. Dana was one of the first to propose and execute upon a private placement funded by its largest creditors while in Chapter 11. Dana was the first major bankruptcy debtor under BAPCPA to successfully emerge with fully committed exit financing after filing its plan of reorganization within the statutory exclusivity period.

Unfortunately, the negative climate that haunted the automobile industry has turned into a hurricane, with the collapse in the credit markets causing consumer demand for automobiles to plummet in 2008. Dana's fortunes are thus somewhat uncertain moving forward. But in a short span of time, Dana, along with the help of Jones Day, Miller Buckfire, and AlixPartners, was able to transform itself from an inefficient behemoth into a solvent company with a capital structure that puts Dana in a much better position to withstand the current economic realities than many of its competitors. It did so through a comprehensive restructuring effort that involved balance sheet restraint, union concessions, improved operating efficiencies, divestiture of unprofitable subsidiaries, and improvements on the terms of customer contracts. When all of these pieces were put together, it resulted in a restructuring effort that warranted Dana being named the Turnaround Management Association's 2008 International Company Turnaround of the Year.

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Finding “Inner Steel”: A Pennsylvania Company’s Remarkable Rebirth

JOHN J. BELLARDINI AND WALTER C. NEWCOMB

In 2002, Michelman–Cancelliere Iron Works (MC Iron) of Bethlehem, Pennsylvania, was a highly respected provider of structural steel for large infrastructure projects in the Northeast. With nearly $24 million in sales and net income of $2.1 million, the company was a respected employer of 110 in a rural area with a reputation for quality workmanship.

Four years later, MC Iron faced extinction with nearly $4.7 million in losses, and a dysfunctional organization and management team. Critics on all sides gave the company little chance of recovery. Yet, with a willingness to persevere, and the strength of an exceptional turnaround team led by JC Jones & Associates (JC Jones), MC Iron found its “inner steel”: the strength to make the deep, lasting changes needed to turn a losing operation around and ensure long-term success. The path was painful, requiring MC Iron’s leaders to leave their comfort zones and remake themselves—as individuals and as a management team—to find and follow a new, more prosperous path.

THE SITUATION

Beneath MC Iron’s veneer of success lurked myriad problems with operations, organization, and processes. These stemmed from longstanding tensions between MC Iron’s founding families—the Michelman family of Michelman Iron Work and the Cancelliere family of Bethlehem Contracting—who had merged their respective organizations to form MC Iron. These tensions had remained hidden as long as sales were strong. When weakened economic conditions in MC Iron’s key markets triggered revenue and profit declines, the problems appeared as rocks in the proverbial stream, blocking recovery efforts and actually accelerating the decline.

In 2004 and 2005, revenues fell more than 30% from a previous high of almost $24 million. Losses exceeded $5 million, reducing equity a staggering 67%. Declines continued in early 2006. If unchecked, the “rocks”—more than the economy—would end the business. Not surprisingly, management was highly stressed and not responding well to the company’s distressed condition. Emotions were high and morale low. In their attempts to reverse the fortunes of the business, managers only worsened things by making bad decisions.

Recovery began when financial losses caused loan agreement violations, and MC Iron’s bankers required outside consulting assistance. This began a chain of events that led to a close partnership between management, bankers, and consultant JC Jones—the core team responsible for recovery.

Allowing an outsider into any business is uncomfortable at best. When encouraged...
by lenders following covenant violations, the process can be both nerve-wracking for management and challenging for the consultant. MC Iron was no exception.

PHASE I: IDENTIFYING THE REAL PROBLEMS

JC Jones’ initial investigation identified significant problems with operations, management, processes, and customer and provider services. Key problem areas identified included poor bidding practices, weak management, poor project execution, and vendor problems. MC Iron’s largest open contract was suffering potential losses that alone could end the business, and most projects experienced regular profit erosion during the last 5% of the work, when labor and material costs regularly exceeded quotes.

The environment was stressful, as facilities and equipment were not productively used, related costs were excessive, and unpaid suppliers threatened to terminate service. The most serious example was employee healthcare; employees were contacted by collectors and denied family healthcare service due to unfunded medical coverage.

Further compounding the company’s problems was a lack of timely and accurate information for decision-making, in particular cash forecasts, profit forecasts, and critical performance metrics.

Digging deeper, JC Jones identified more serious and complex problems. Management’s direction to employees was poor and inconsistent. Responsibilities and authority were unclear and often overlapping, particularly with key individuals in parallel roles as managers, employees, and owners as well as between management and employees.

Business processes were arbitrary and poorly executed. Employees quoted jobs informally, with bids based on emotional arguments. There were regular disruptions in engineering, production scheduling, and equipment maintenance. Decisions were based on personal bias and gut instinct, using little or no data. Teamwork and communications were nonexistent.

Management behavior created a fearful workplace for employees with a regular pattern of reactive, inconsistent, and verbally explosive behavior. All this, combined with a concerned and increasingly vocal labor union and declining employee morale, made the MC Iron workplace excessively stressful.

In the financial arena, working capital was poorly managed. There were mismanagement of past-due accounts, lost discounts, and hurry-up payments for “squeaky-wheel” vendors.

Most turnaround engagements focus primary attention on restructuring debt or achieving Chapter 11 bankruptcy protection. While both are often critical and almost always planned as a backup, they seldom fix the fundamental issues that caused the struggle in the first place.

At MC Iron, the easier path would have been to ignore these fundamental core issues, but in the end the company would have failed. Gaining control of all of the company’s processes and implementing deep changes throughout the business were the only ways to ensure survival. Achieving these goals was not possible without: 1) a rifle-shot focus on key value and profitability indicators, and 2) aggressive action by a strong, cooperative team from MC Iron and the bank, with strong team leadership by JC Jones partner John Bellardini.

“Upon arrival at MC Iron, we found an organization that was in constant reaction mode,” said Bellardini. “The company needed the noise cleared, priorities communicated and very specific, focused action. Management allowed room for the turnaround to occur, but not without some struggle and reluctance. To their credit, they quickly grasped the value JC Jones brought to their situation and leveraged it to its fullest.”

The key to a successful turnaround is getting the priorities right—doing first things first and putting the rest on temporary hold. That meant focusing all resources first on “stopping the bleeding”—activities that would kill the business if not immediately fixed—and then fixing the remaining core business issues that might be equally important, but not as urgent.

PHASE II: STOPPING THE BLEEDING

JC Jones recommended three immediate actions:

- Gaining control of cash by implementing 13-week cash flow forecasting and actions to overcome upcoming “cash walls.”
- Containing costs by aligning workforce resources with contract requirements, eliminating overtime, adjusting management compensation, and selling non-performing assets.
- Restoring employee healthcare benefits by negotiating cost-forgiveness directly with healthcare providers.
In two major moves, management hired a financial controller and negotiated an exit strategy with the largest in-process contract, a potential business-ending showstopper. This project had a poor and explosive customer relationship, excessive quality inspections, and fundamentally flawed contract conditions that virtually guaranteed severe financial losses, even if completed on budget under existing terms, due to project delays, material cost increases, and labor acceleration.

Throughout, the team worked closely with MC Iron’s bankers to ensure their support during critical supplier and customer contract negotiations. Consistent and constant communications with the banking partner created a trusting environment that provided the bank visibility to the turnaround’s actions while allowing the bank access to critical information and input prior to decisions being made. This supportive and almost consultative role was key element in the turnaround’s success. Prompt disclosure to the bank eliminated “surprises” and generated confidence in management and the turnaround team. With the bank’s detailed understanding of the turnaround plan, MC Iron was able to gain the financial support required from the bank, while the bank was able to understand its risk, take appropriate precautions, provide ideas and input, ensure its rights, and help the company achieve success.

These initial actions bought important time for the team to implement permanent solutions in organization, processes, and controls.

**PHASE III: FIXING THE BUSINESS**

At this point, JC Jones and MC Iron management focused all attention on five key initiatives:

1. Customer projects—reviewing each potential and existing contract to implement controls to ensure profits, in particular:
   - Improving project pricing and margin by quickly implementing stronger project estimating, management processes, and disciplines.
   - Instilling discipline to walk away from potentially unprofitable projects no matter the size.
   - Implementing improved project management processes to ensure a successful financial outcome.

2. Working capital and cash flow management—with particular focus on billings, collections and structured vendor management.

3. Business operations—restructuring processes, cutting costs, and increasing production efficiencies.

4. Performance measurement—implementing key indicator measurement and management.

5. Creating backup plans—implementing a legal strategy with the bank and a backup bankruptcy plan.

Along the way, there were many decisions no one would look forward to, including suing the company’s largest and most important customer and terminating employees who were not contributing to the success of the business. JC Jones helped management through these decisions and helped them understand that leadership and accountability are fundamental management responsibilities that can and must be learned if a company is to succeed.

As these initiatives were completed, management began to see measurable improvements in efficiency and profitability, and the business began to stabilize.

**PHASE IV: RECOVERY AND TRANSFORMATION**

Business stabilization provided some relief, but the pressure of the company’s financial condition was always present and severely stressful to management and employees alike. While MC Iron management was now ready to drive necessary long-term improvements in core business processes, the organization could no longer afford to continue its traditional patterns of dysfunctional and disruptive behavior. In addition to strengthening critical core processes, strong focus needed to be placed on identifying and correcting unacceptable behaviors. Management needed to learn to act and behave as leaders, and set the example for all employees. Accordingly, with JC Jones’ assistance, the team now turned its attention to the following two remaining long-term recovery objectives:

1. Strengthening core business processes:
   - Backlog and revenue projections.
   - Cash flow forecasting and analysis.
   - Unbilled contract management—internal reporting and invoicing.
• Timely project close-out.
• Cash disbursements and supplier management.
• Management and elimination of non-performing assets.

2. Improving leadership, accountability, and communications to increase business focus, sense of urgency, and intensity of the workforce:

• Defining and solidifying organization and reporting structure.
• Assigning roles and responsibilities for key functional positions.
• Fixing major problems in owner and management dynamics.
• Resolving key behavioral problems and practices among owners, managers, and employees.
• Implementing measures of key indicators of individual and company performance.
• Developing a strategy to communicate plans and results internally and externally to appropriate parties in a timely and consistent fashion.
• Developing and implementing succession planning for key positions.

The most difficult tasks facing the team were those related to overhauling MC Iron’s core organization, management style, and company culture. Changing culture is tough, but management needed to learn to make decisions based on fact, not feeling, and to resolve their many interpersonal, family, and management issues to help them work together better as a team. To assist, management agreed to retain Grenell Consulting Group, industrial psychologists, to help improve management of individual and team dynamics, and to help resolve the many serious interpersonal, management, and related process problems.

“In many family-owned businesses, emotions and/or seniority drive leadership decisions,” said Judy Fox, Grenell Consulting Group senior consultant. “At MC Iron, the CEO was struggling to lead in such an emotionally charged environment. With the right support and encouragement, the CEO’s growing confidence and leadership calmed the chaotic environment and got the company back on track. Under improved conditions, the company was able to spend more time and energy improving the business and less time talking about the business.”

In order to address the many management and employee interpersonal behavioral issues, the turnaround team began to implement simple changes by creating basic team and interpersonal work rules. The following two examples illustrate:

• Meeting Interruptions: Meeting interruptions were a common and accepted practice. For example, frequent and abrupt interruptions of confidential closed-door meetings in the CEO’s office for petty problems were regular occurrences and were considered acceptable. The explosive behavior that came with these interruptions would disrupt meetings for issues of significantly less importance that could have been handled later. A meeting scheduled for one hour would regularly be interrupted three to four times. The original reason for the meeting, the more important issue, would remain unresolved.

  Reactive interruptions had to be addressed. To resolve the problem, the team implemented a basic interpersonal and team work rule. The CEO created a door sign. He posted the sign, locked the door during critical confidential meetings, and refused to address anyone who interrupted. After the first test, the frustrated employee went away. Word spread quickly. The organization had taken its first step to establishing business decorum. Clear communication of expectations, consistent application, and clearly defined consequences quickly resolved this simple but highly disruptive practice.

  At the core, this example of reactive cultural behavior resulted from limited planning and poor strategic focus.

• S.M.A.R.T.: Conflicting instructions by different owners—instructions often well intentioned but neither timely nor aligned with company objectives—were significant time wasters that caused employee confusion and frustration and excessive time to resolve. The conflicting directives resulted in inaction to avoid punishment and eliminated any sense of employee accountability or responsibility.

  To resolve this matter, management implemented and coached a simple work rule designed to bring structure and business focus to directives, instructions, meetings, and other communications with defined objectives, actions, and timetables. All directives and communications needed to be
S.M.A.R.T — **Specific, Measurable, Aggressive, Results-driven, and Timely.**

S.M.A.R.T feedback was also important. Employees and managers who violated the rule received strong feedback from those impacted.

These and other simple work rules helped employees gain increased understanding of expectations and visibility to customer requirements and company goals. Management quickly learned the disruptive impacts of their own behaviors and led improvements by example. This generated the velocity needed to accelerate the rate of change in communications and performance. Employee involvement and participation increased immensely as a result.

**Deep Change Brings Lasting Results**

In little more than a year, recovery was complete and lasting. Today, MC Iron is a different business—driven, successful, and forward-thinking. By late 2006, net earnings reached $4.5 million, a swing of $6 million in profitability in one year. Today, the company remains EBITDA-positive and is making substantial strides toward sustained and long-term profitability.

Of greater significance, MC Iron’s bankers returned the company to a normal commercial lending relationship. Management now has a comprehensive understanding of its cash flow, and its largest customer reconciled to the point where MC Iron saved hundreds of thousands of dollars in penalties.

Today, MC Iron is considering further business development and potential acquisitions. Most significantly, it is a business with productive, creative people who know how to make decisions. They are researching new markets, new cost savings, and strategic alliances. MC Iron now has the “inner steel” to forge a bright and prosperous future.

**PHASE V: FINAL STEPS**

Certain improvement actions could not be addressed during the turnaround and while MC Iron was living under a forbearance agreement with the bank. Issues such as shareholder structure, debt structure, and establishment of an active board of directors had to wait until the company could demonstrate a sustained period of profitable performance and the forbearance agreement was a thing of the past.

Once the company had returned to profitability and the forbearance agreement was successfully ended, MC Iron’s bankers returned responsibility for their loan from the workout group to commercial lending, signaling their confidence that the company was truly turned around and out of “distress.”

The company could now afford to work on other profit improvement and structural opportunities. A Lean Six Sigma consultant was brought in to drive labor efficiency and utilization improvements. New hires in sales and purchasing allowed for increased focus on market and selling strategies while fine-tuning purchasing methods.

Of significant importance was the new company legal counsel. Previously, confusion among family members as to their different roles as shareholders, employees, and board members created an environment that clouded decision-making authority. In response, management retained a legal professional to properly document legal structure, shareholder relationships, and other corporate requirements. This area is now being reviewed and is the first step before establishing a board of directors that can help provide the knowledge, skills, and abilities to complement existing management.

**TAKE-AWAYS: LESSONS LEARNED**

During the course of MC Iron’s turnaround, many lessons were learned—some new, while others re-enforced consistent themes from past turnarounds. Here are a few that were key to MC Iron’s recovery and apply to most turnaround situations:

- **Choose the right team.** While the premium may appear high at the front end of a turnaround, a well-coordinated team of true professionals generates the strongest return on investment, in terms of both hard-dollar and soft-cost value. Critical internal and external team members include a turnaround consultant, banker, attorney, accountants, a strong internal leader, and others from operations, finance, and human resources.
- **Find and fix the core business first.** Without a core business, recapitalization does not stop the inevitable and may only deepen a hole from which a company can never escape.
• *Avoid the “bankruptcy first” trap.* Bankruptcy is a valuable tool, but an expensive alternative that should not always be a first choice. Too many companies enter bankruptcy at the first sign of serious trouble. The result is both costly and distracting when all efforts should be focused on fixing the core. Fix the business first. Use the bankruptcy tool for the right reasons.

• *Focus, focus, focus.* Keep everyone focused on fixing the core business first, before dealing with all other distractions. Never lose sight of the end goal. Keep the desire high. Constantly challenge and adjust plans. Be flexible with vigorous action. Mistakes will be made, but always re-focus and move steadily forward with flawless execution.

• *Stay in balance and keep your perspective.* Great turnaround teams really get involved. They get passionate about the business. At the same time, however, they must use subjective evaluation tools, and keep emotions in perspective. Balancing these seemingly opposite perspectives is critical to success.

• *Maintain a broad perspective.* The time and effort to fix a company requires cohesive flexible planning. Often the best choice is not the easiest but will provide the foundation for the highest probability of long-term success.

• *Seek guidance and education.* Everyone has an opinion and is often more than willing to share and help. Some opinions are good, some bad. Seek knowledge from a variety of sources, but develop a filter. Do not over-rely on one professional, and be sure to validate with second opinions. In the end, be sure that you are comfortable with each critical decision. If an issue is too difficult, select and entrust a few team members to guide you to the decision.

• *Plan, plan, plan.* Plan ahead, have a backup plan for everything, and another backup plan for the backup plan. Problems are usually solvable. Problems accompanied by surprise and fire drills are much more difficult.

Taking the road less traveled through the hard work of a turnaround builds a stronger foundation for companies to grow and prosper once they emerge from distress. Companies that do this rarely make the same mistakes in the future that got them in trouble. The skills they learned help them to continue to grow and prosper. Turnaround professionals’ successes are measured by the extent to which the company no longer needs their services.

*To order reprints of this article, please contact Dewey Palmieri at dpalmieri@iijournals.com or 212-224-3675.*
In early 2006, the family board of Roman, Inc. was faced with making a series of gut-wrenching decisions. The founder, Ron Jedlinski, always wanted to pass along the business to the next generation, but Roman had struggled over the last couple of years.

The family-owned business had grown to be an industry leader and had reached $125 million in sales. Roman had a strong management team in place: Son-in-law Dan Loughman, the heir apparent to become president, ran one of the divisions and headed up Product Development, and CFO Pat Pipp had a great deal of experience and operations capabilities.

The ties between the family and the business were critical. Every employee was a member of the family; many had been with the company for 10, 15, or even 30 years. Roman, its employees, and the family were a group that had grown up together. Success had not been easy, but when it arrived, it had come in spades, and the family shared that success with its employees generously.

However, over the prior six years, competition from Internet merchants, expansion of mass retailers into smaller communities, margin pressure from mass retailers, loss of key distribution rights, and excessive personnel and facility overheads eroded the profitability of what had been the market leader in Christian, religious, and spiritually oriented gift items.

Roman had faced difficult times before, but the combined impact of the considerable changes to the giftware industry had reduced the company to $65 million in sales with annual losses of more than $3 million.

The company was put up for sale and a bidder stepped forward, but the transaction fell apart in late 2005, just before closing.

The Roman board determined that closing the business was its best option. It would be easier to liquidate the 40-year-old company than to face a painful and uncertain reorganization and restructuring process that would require difficult decisions, agonizing personnel choices, and drastic change.

The plans were put in place to liquidate the business. Times were tough, family relations were strained, and anguish over the decision made going to work difficult. The senior executives knew their fate, but the employees had no idea.

THE BEGINNING OF THE JOURNEY

Roman had come a long way in three generations. In 1963, Ron Jedlinski borrowed $500 from his parents to start the company out of the back office of his family’s art and gift shop on Chicago’s Cicero Avenue.

Focused on religious articles like rosaries (the standard boxed rosary is still...
item number nine—a solid seller 40 years after its introduction), as well as first-communion, confirmation, and wedding keepsakes, Roman grew to become the leader in its industry. The profitability of the main line of business was fairly constant over the years, with significant revenue growth coming from various line extensions. A move into Christmas ornaments, pre-lit Christmas trees and lights, and seasonal giftware items, and the explosion of the collectibles business during the 1990s grew revenues and profitability.

Roman grew to annual sales of $125 million through an abundant product offering of 15,000 items, occupying 525,000 square feet of warehouse and showroom space in two facilities, and employing more than 330 people.

For many years, Roman’s growth was based on three consistent themes: original product development, variety of sales channels, and superior customer service.

Product development:

• Roman developed original items, which it sourced from Asia and Europe.
• Internal artists and groups were hired to work for Roman to develop unique artwork, jewelry, picture frames, and other fashionable items.
• An in-house staff of artists, photographers, and product developers produced 15 to 20 catalogs and brochures annually for the various product lines.
• Over the years, Roman successfully leveraged its position within the giftware industry to obtain highly prized licensing agreements with key players like Disney, Warner Brothers, Better Homes & Gardens, and Peanuts.

Sales channels:

• Roman’s unique blend of original items, reputation for strong quality and service, a good sales network, and efficient distribution capabilities allowed it to attract and service such mass market outlets as Ace Hardware, Sears, and JC Penney.
• More than 100 independent sales reps called on more than 16,000 local independent gift and religiously oriented shops.
• The company began selling to consumers directly over the Internet, launching two websites.

Customer service:

• Led by Tony Jedlinski, the founder’s brother, the IT department developed a home-grown, web-based system built on novel Oracle database technologies, which allowed the company to grow and manage orders and warehousing efficiently as it moved to online ordering and off-site order-taking tools with real-time inventory information.
• Sales representatives could check inventory and place orders in real time using handheld devices.
• Customers had access to order status and purchase history online.
• The company earned the number-one ranking for customer service six years in a row from Giftbeat, a leading gift and collectibles trade publication.
• Roman garnered numerous prestigious awards:
  1. The company received the National Gift Organization’s Vendor of the Year award three times.
  2. It was selected three times by the organization’s membership of specialty retailers as the manufacturer that best served the industry by providing superior products and responding effectively to retailers’ needs.
  3. The National Gift Organization awarded a Golden Award of Honor to Roman’s founder, recognizing outstanding commitment, leadership, and dedication to the collectibles industry.

Roman had built a niche for itself and was reaping the rewards of providing products and services valued by the industry.

The company enjoyed great success. A series of professional managers gradually took the reins as Jedlinski stepped away from the daily operations. A third generation was working in the company, with son-in-law Dan Loughman, in product development, heading up the Christmas, pre-lit tree, and light divisions. The fourth generation had already expressed interest in one day working at Roman.

**CHANGES CREATE CHALLENGES**

After many successful years, Roman experienced such severe losses in 2004 and 2005 that the owners questioned whether the company was still viable. Causes included:
Mass market merchandisers forced closings of small retailers:

- Over the past 10 years, many of the small giftware and religious article stores that represented the core set of customers had been driven out of business.
- Roman’s core group of small giftware shops was in a state of rapid decline. As recently as the late 1990s, Roman had as many as 16,500 customers, which had declined to less than 10,000 by 2004/2005.

Margin pressure: Impact of the Internet on the collectibles marketplace:

- The collectible business grew rapidly, as Roman’s in-house staff and network of independent artists provided it with a strong competitive position. They released several successful lines of superior-quality, high-retail-price-point items that drove profitability.
- As the collectible market grew during the 1990s, annual releases became a driver of new business, driving SKU counts and inventories upward.
- Other designers and manufacturers of collectible items came into the market, driving awareness, propelling sales, and providing small gift shops with a product line that allowed them to compete against mass-market offerings.
- As the collectible market became saturated, margins were constrained, but the annual release of new units capitalized on the inability of older collectible items to get to market in any sustainable form.
- However, starting in the late 1990s, eBay and other online marketing channels provided individual collectible owners with a marketplace for their items.
- The value of collectibles dropped as the secondary market for those items became more efficient, which lowered prices.
- Sales of new releases slowed as older collectibles came to the market in large quantities.
- Discounting by Internet retailers cannibalized sales from higher-priced retail locations.
- Within two years, a $36 million business for Roman fell to $14 million as unit volumes dropped and lower-priced/margin items replaced high-dollar-value items in the product line.
- Old inventory sat and had to be held or sold for significant discounts.

Discount levels were maintained despite lower sales levels:

- Roman fell into the same trap as many wholesalers by honoring prior-year or historical discount levels for customers as sales dropped.
- Higher-margin collectible items were replaced by lower-margin, more competitive market segments, such as trees, lights, and general giftware categories.
- Roman increased discounts to some customers as part of a strategy to retain a greater share of a smaller customer base.
- Gross margins declined on a per-unit basis, which impacted overall profitability, as critical shelf space at the increasingly smaller set of giftware shops was being filled with lower-priced items at a higher discount.

Lack of appealing product developed by the gift industry in general:

- Consumers have traditionally been driven into small retailers by hot products.
- Precious Moments, Hummel, Department 56 Villages, and Seraphim Angels are all examples of products that have driven consumers into small retail stores.
- Beanie Babies were the last hot collectible, driving thousands of consumers into small retail stores in the late 1990s.
- When consumers come to the stores, all of the companies in the gift industry benefit.
- The industry did not have a hot, customer-attracting product since Beanie Babies, reducing customer traffic and contributing to the closing of store locations.

Loss of key distribution rights:

- Roman had distribution rights for a tree and light line that it was selling since the mid-1990s and was having great success at good margins.
- Due to declining sales through its distribution channels in the late 1990s, Roman lost its distribution rights.
- Roman started its own tree and light line, but sales in this area fell from $24 million to $12 million in one year.
The development of the tree and light line took time, and in the interim period, Roman had to discount product to maintain sales and move inventory.

Fixed overhead issues:

- Over the years, personnel hired to meet peaks in the business cycle became permanent fixtures. When the company was at similar revenue levels during 1993–1994, it had 170–190 employees, whereas in 2005, it employed over 210 people, an increase of 17%.
- Limited employee turnover resulted in wage creep over the years, resulting in higher average compensation.
- Overhead in 1993–1994 was $12–$14 million, or about 26%–28% of sales. In 2005, when revenues were at a similar level, overhead was $26 million, or about 39% of sales.

Warehousing fixed cost problems:

- The family-owned warehouse cost the company almost $3 million in 2005 (including rent, taxes, and utilities).
- Warehouse employees peaked at 164 in 1999 and had slowly been worked down to 90 by 2005. However, this was still 15% higher than historically comparable sales periods.
- Warehouse was staffed to meet the peak volume of the summer/early-fall period, but was overstaffed for the rest of the year.
- During the 2004–2005 period, the company absorbed the cost of owning two warehouses as the new facility was constructed, built, and finally moved into during 2005.

THE END OF THE ROAD?

The impact of the changes to the industry was dramatic. Roman’s sales dropped almost in half, from $125 million to $65 million. Profitability went south, and during 2004–2005, losses were more than $3 million annually. Eventually, it was determined that a sale of the business was the best way to move forward.

During 2005, the company put together a marketing plan for the business, and went out to the market and found a buyer. Negotiations went late into 2005, when the buyer ultimately backed out of the deal. At that point, company executives saw no alternative but to develop a liquidation plan.

Management put together a liquidation plan that incorporated two key aspects. First, Roman reached an agreement to sell its building, with an anticipated closing date of July 2006. Second, management initiated reductions in personnel levels as part of the planned downsizing and began liquidating inventory.

Roman anticipated a recovery of $2–$3 million on the liquidation but had a couple of key areas of concern:

1. Christmas business was sold based on a due date of December 10. In early December, accounts receivable would be in excess of $25 million.
2. At some point during Q3, it would become obvious to vendors that they were not purchasing goods for the next season, which would announce their plans to the community.
3. Retailers placed orders for shipment in Q2–Q3 and reordered throughout the holiday season. Any indication that the company was not going forward would cause cancellations and eliminate reorders, reducing sales and potentially putting a large portion of the AR at risk.
4. Trees and lights carried 5- to 10-year warranties, which would have to be managed, and retailers might stop selling units that wouldn’t be under warranty, or claim offsets against open AR in lieu of having a warranty on the goods.

In early 2006, Bank of America Business Credit (formerly LaSalle Bank) suggested to Roman that it seek the assistance of a consulting firm to improve the recovery under the liquidation plan. This was not a decision that was arrived at easily. Roman had been a customer of the commercial bank for over 40 years, and only with its recent troubles had the workout group become involved with the relationship. The workout group pushed to obtain the assistance of an outside consulting firm. When Roman determined that liquidation was in the works, the workout group was allowed to make its recommendations to Roman.

A NEW BEGINNING

Initially, MorrisAnderson was hired to perform an evaluation of Roman’s liquidation plan and to provide options to increase the recovery of the liquidation. The process was to take two weeks. During the initial
evaluation period, MorrisAnderson determined that there were lines of business that not only had potential value as ongoing businesses, but that there was a core set of SKUs and business segments around which the company could be profitably restructured.

The new business plan included:

1. Reduced SKUs:
   a. A core line of 4,800 mainly religious oriented items were identified from a total SKU list of 12,800 items that had sales during 2005–2006.
   b. Core SKUs had a baseline sales rate of $30 million, which was fairly consistent over the prior three- to five-year period.
   c. Best sellers and key items were added from other departments (giftware, Christmas) to the core list to round out the product offerings and to develop a stable base of products on which to build a downsized company.

2. Reduced inventory:
   a. The mandate for fewer SKUs reduced the amount of new items introduced each year, which in turn reduced inventory pre-buys.
   b. Older inventory was sold off, which along with the reduction in overall inventory, generated $5 million in working capital.
   c. Inventory turns were increased from 4.5 to 6 times annually.
   d. Inventory levels were reduced from $14 million (high point) to under $7 million.

3. Reduced warehouse space requirements:
   a. Prior to the downsizing, warehouse utilization was 351,000 square feet.
   b. The new business plan forecasted usage of 96,000 square feet.
   c. Reduced space requirements pushed fixed warehousing costs down from $2.7 million in 2006 to a projected $800,000 in 2007.

4. Staffing:
   a. Overhead staffing was resized from 213 at the beginning of 2005 to 152 in April 2006, finally ending up at 72 full-time equivalents.
   b. Warehouse staffing was adjusted to have a more variable cost structure.

5. Showroom space:
   a. The corporate showroom at the company’s headquarters was eliminated.
   b. The showroom at the Chicago Merchandise Mart was modified to become the corporate showroom.
   c. The need for about 7,000 square feet in the new smaller headquarters building was removed.
   d. The size of regional showrooms in Atlanta, Dallas, Los Angeles and Minneapolis were reduced to decrease rent expense.
   e. Total showroom space went from more than 42,000 square feet in 2006 to 25,000 square feet in 2007.

6. Reduced business lines:
   a. The sale of the tree and light line, which accounted for approximately 20% of sales, was negotiated and completed. Reasons:
      i. The line sold at lower margins.
      ii. It was the primary need for having a larger warehouse, due to the large amount of high-cubic-space tree inventory that needed to be carried in the third and fourth quarters each year.

7. A 90-day loan extension with Bank of America allowing for the restructuring plan to be finalized:
   a. MorrisAnderson and company management presented the turnaround plan to Bank of America, which requested a smaller, but still substantial, seasonal buildup of inventory and AR.
   b. Mitch Rasky, Dan Gallagher, and the team at Bank of America provided the required flexibility that allowed for the seasonal build.
   c. Once the company made it through the winter 2006 season, beating budget and making the necessary expense cuts and overhead reductions, Bank of America provided Roman with a more permanent working capital line of credit.

**GOOD RESULTS FROM HARD WORK**

As part of the plan, Dan Loughman was made president of Roman, and Pat Pipp was promoted to CFO/COO to allow the new management team to push the agenda of change through the organization.
Loughman and Pipp adopted the plan as their own, bringing a new sense of ownership and pride to the company. Both were instrumental in developing a new culture of success within the business.

In 2004–2005, Roman averaged $66 million in revenues, but losses each year were $3 million. Earnings before interest, taxes, depreciation, and amortization (EBITDA) were break-even or a $500,000 loss. Due to the timing and costs of the transition to the smaller warehousing space, the resulting $66 million in sales reduced Roman’s loss to $500,000 and increased EBITDA to $1.8 million.

The sale of the warehouse facility closed in October 2006, and Roman moved into its new, smaller facility during Q1 of 2007. Revenues were well above the business-plan forecast of $35 million, approaching $44 million. Pre-tax income was just shy of $1 million and unadjusted EBITDA was over $1.5 million. When adjusted for restructuring, EBITDA charges were more than $2.5 million—not bad for a company that just 18 months earlier was hoping to net $2 million from the liquidation.

Bank of America funded the company with a $15 million asset-based facility for annual working capital requirements.

The turnaround has presented Roman with some welcome challenges. Customer reaction to the company’s renewed focus on its core business lines has been excellent. Sales have been higher than the initial restructuring plan estimates, resulting in a nice problem to have: Roman is now considering expansion.

Bank of America agreed to move management of the account from the asset-based group back to the commercial group. The change resulted in better interest rates and reduced banking costs for Roman.

AN UPDATE

In 2008 Roman was awarded the Turnaround Management Association (TMA) Chicago/Midwest Chapter’s Medium Turnaround of the Year Award, and the TMA International Mid-Sized Turnaround of the Year, Honorable Mention.

Also in 2008, Roman refinanced its debt facilities with The Private Bank, and in October merged with another family-run giftware business, Cottage Garden. The breadth of the Roman sales channels will help bring the innovative products developed by Cottage Garden to a wider range of buyers. Cottage Garden will be a division of Roman once the merger is complete.

Dan Loughman and Pat Pipp make up the core of a strong management team committed to building upon the solid foundation that was developed as an alternative to liquidation.

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Private equity groups that own middle-market companies are like all other equity owners: they are attempting to earn a return on their investment in their portfolio companies. When the portfolio companies fail to meet expectations, the tendency may be to either ignore the underperforming company or micromanage the company. Private equity group (“PEG”) managers should consider retaining turnaround advisors to assist them with their underperforming companies so they can continue to manage all companies in their portfolios without dedicating a disproportionate amount of time to the underperforming company. Qualified turnaround advisors understand the concerns of PEG owners and can help the portfolio managers make better decisions relative to their underperforming portfolio companies.

CASE STUDY 1

The subject company provided retail products and professional services and was a leading provider within its geographic area. The company’s owner served as president, but was unable or unwilling to devote all of his time to the management of the company. At the same time, however, the president was unwilling to recognize the negative impact that his absentee management had on the business’ performance. The president refused to recruit a qualified manager to whom full operational control could be delegated. This would have had a significant and positive impact on the business because the customers and employees would have the benefit of a full-time, on-site leader.

r² advisors llc began working with the company and helped the client prepare and implement an out-of-court turnaround plan. With the formal turnaround plan, the owner was able to obtain additional equity from an investor. The plan was successful from a financial standpoint, but the business continued to suffer from a lack of leadership. Three years after the turnaround, the lack of leadership manifested itself in the form of severe financial distress, and the owner decided to file for Chapter 11 protection. Once again, the owner failed to accept the now apparent reality that his lack of leadership was dragging the business down. The consequence of maintaining the status quo was that the business was back in the same condition it was in three years prior.

Being in Chapter 11 brought a new sense of urgency to the owner’s dilemma. Unfortunately the owner again failed to be deliberate in his actions and squandered an opportunity to either address the leadership issues or to sell the company to a strategic buyer who quickly offered a very fair price for the business. Over the next six months, three other offers came and went. Finally,
the original buyer returned and made another offer—at roughly 50% of its original offer. The owner had no choice but to accept the offer. From a pure bankruptcy perspective, the outcome was acceptable since the price paid satisfied all creditors in full, but there was no return to equity. In the end, the equity owner realized that the consequence of his inaction was that he lost his investment in the company.

CASE STUDY 2

The subject company was an established manufacturer of recreational vehicles and was recognized as the leader in its market niche. After many years of family ownership, the business was sold to a private equity group that used a significant amount of leverage to complete the purchase. Based on its pre-closing diligence, the new owners were aware of improvements that were needed to transition the company from family ownership to professional ownership. Among the identified improvements, the most important ones were to implement more effective accounting and finance systems, to upgrade their mid-level management, and to improve the company’s internal processes.

However, the new owners delayed making these changes for a few years because revenues were stable and there was a lack of urgency. Unfortunately, the impact of waiting to implement the necessary changes became apparent as soon as revenues began to decline with the economic downturn. By that time, it was for all intents and purposes too late. The company’s lender was frustrated that the changes had been discussed for two years but had not been implemented. As a consequence, the lender believed that the company’s reporting was insufficient to manage the company through the downturn. The company did not have tight financial data to support its business case that the company could reduce production levels and run very lean through the economic trough. All of the company’s known weaknesses became significant obstacles to a workout.

Although the lender was willing to work with the company, it could not wait as long as the company requested in order to implement the needed changes. When r² advisors was hired, the company had neither the time nor the financial resources to implement the changes that were needed. In the end, the lender recovered the value of the company’s assets, which in turn were acquired by a distressed equity investor who is operating the business under a different business model. In this case, the business continued but equity did not receive any return on its investment. The outcome could have been significantly different if the company had implemented the changes that were acknowledged to be necessary when the ownership change occurred. The delay was costly and in addition to the investment loss, the owners committed significant time to the project during the nine-month workout period.

CASE STUDY 3

The subject company was a 10-year-old manufacturer of steel structures. The founder and sole shareholder was an exceptionally talented sales and marketing professional. The company was performing adequately until an unexpected increase in the cost of its primary raw material exposed the company’s weaknesses. The company’s internal processes were fairly weak, and its financial function inadequate to manage the business through any real difficulty. The owner sought assistance as the plant was idled and the company’s creditors started collection lawsuits.

r² advisors’ first steps were to rationalize the business model and confirm that the business was capable of making a profit. The second step was to organize the company’s creditors in an informal out-of-court committee to explain our strategy for working the company out of its distress. Next, the company’s manufacturing plant was restarted.

The business was stabilized over the next 18 months. The employee roster underwent a significant transformation, and new processes were implemented. At the end of the turnaround period, the owner decided to sell a majority stake in the business to provide additional support for the business, both in capital and human resources. The owner knew his strengths, but he acknowledged that his weakness was the administrative side of the business. That was almost his undoing, because he was unable to stay ahead of the damage that rising costs were doing to his business. Fortunately, this story has a positive ending. Because of the owner’s foresight and his willingness to confront the reality of the position that his business faced, he was able to restructure the company into a much stronger, better capitalized, and more sustainable entity.
LESSONS LEARNED

Be Very Honest and Objective in Your Assessment—Then Act

It is critically important to honestly and objectively assess the underperforming company’s problems. Many times, clues to the weaknesses are found in the original diligence and underwriting reports that were prepared prior to acquiring the company. Every effort should be made to identify the facts that constitute the root causes of the problems, rather than allowing decision-making that is based upon speculation, surmise, and guess-work. Address the problems very deliberately and spend the time necessary to get the facts in front of the decision makers.

Although time is extremely valuable, it is highly unlikely that the problems can be fixed overnight. Accordingly, it is important to be realistic about the time frames that will be involved in the turnaround and allocate time to each phase appropriately. Like the carpenter’s mantra, “measure twice, cut once,” professional managers should assess their situation fully before taking action. Of course, this must be applied in the context of the situation, and adjustments will have to be made if the situation is dire. However, the most effective leaders will gather all of the facts regarding the situation and not simply react. Often, there is more time than it may at first appear.

A critical component in the process is that the stakeholders in any business must take full advantage of every opportunity to address weaknesses in their portfolio companies. Usually, the weaknesses are known up front. Like the owners in Case Study 2, often it is simply a function of implementing the changes that are needed. However, the changes must be implemented by effective leadership, which often must come from outside the company’s existing management. This is simply due to a function of human nature; if the existing management wanted to implement the change and was capable of implementing the change, they would have accomplished the tasks without outside influence. If the stakeholders are confronting the situation, almost by definition, the change will have to be driven by a player new to the team.

It is helpful to keep in mind the following parable:

Every morning in Africa a gazelle wakes up. It knows it must outrun the slowest gazelle or it will starve to death. It doesn’t matter whether you are a lion or a gazelle.

—when the sun comes up, you had better be running.

However, do not mistake motion for progress. Once a company’s weaknesses have been exposed, it is critical to make consistent progress toward addressing the weaknesses for several reasons, but the most important is credibility. This credibility will manifest itself in the way employees and creditor stakeholders respond to the company’s management when it is time to enlist their support. At the end of the day, it is people who make the difference between success and failure, and it is important to engage the people who are indispensable to the process. The simplest way to do that is to maintain credibility so that they will not question the direction they are given. Once credibility is questioned or lost, it is very difficult to recapture.

Return to Business Fundamentals

To paraphrase Warren Buffet, we see who is swimming naked when the tide goes out. It is important at all times, but critically important during the current economic downturn, for businesses to understand the fundamentals that make them run profitably. No matter which way the business goes—whether it is operated by its existing ownership or sold—the only way to really understand the business’ enterprise value is to understand the fundamentals.

The economic fundamentals must be broken down into their component parts so that they can be explained, in plain and simple terms, to the various interested constituents. It is far better to understand the business before going into a difficult period. Actually, if one understood the fundamentals and adapted the business to the environment, the business would never encounter true distress. Nonetheless, once the owners and managers of a business understand that they are confronting a crisis, they should return to the basics of their business.

If management is unable to get down to basics, the PEG owners should take steps immediately to find competent replacements or outside consultants who can drive
the process to a satisfactory conclusion. That conclusion should consist of a concise and easily comprehensible statement of operating margins, breakeven points, expense management, and the key drivers of revenue. Too often, managers face the circumstance where their subordinates are incapable of determining these important key drivers and will surrender to the notion that “the business is very complicated.” The most effective owners and leaders will not allow this to happen. They will take control of the situation and find people who are capable of identifying the answers and who will not accept anything less than an accurate and defensible understanding of the business.

Every business has unique aspects. Therefore, template or cookie-cutter approaches to problem solving do not work in all cases. Each business must be taken on its merits. Critical employees must be interviewed to truly understand the business challenges from their perspective. The analysis should start from the basics. In determining the cost factors that impact the business, the analysis should start with the base-level data such as engineering plans, bills of materials, and vendor invoices. These should be assessed for accuracy, and all weaknesses in the cost of goods should be exposed. Production statistics should be compared to industry benchmarks and deviations should be understood. Do not allow rationalizations to creep into the analysis; conclusions should be reached using fact-based data.

An ancient Chinese philosopher, Lao Tzu, is credited with saying, “a journey of a thousand miles must begin with a single step.” It is important that all the stakeholders facing a crisis understand that the problem likely will not be solved overnight. After all, it probably took years to get into the situation, and it is unrealistic to expect that the problem can be resolved instantly by some sort of magic.

It is equally important that those leading the change not be deterred by obstacles, whether internal or external. An internal challenge may be obstinate employees, who must be made to understand the importance of the task; if they do not accept the challenge, they must be replaced quickly. An internal challenge with an external component may include an initial lack of capital that must be overcome through a focused effort to demonstrate that the restructuring process is on track and the incremental value in completing the process.

One of the key outputs of this effort is to identify processes that can be implemented to help the company and its employees maintain discipline. Once it is determined that the business can operate profitably, implementing processes will help the company avoid inadvertently adopting behavior that will lead to unprofitable operations. By maintaining strict adherence to inventory purchasing and control functions, production efficiency, and sales and credit policies, the company should be able to ensure that no one individual can take the process off track. Sometimes, the development and implementation of policies is seen as a negative process, and it is true that process implementation can be overdone. But that is no reason to discard process implementation. Often, those who object the most are the ones most in need of process control.

At the end of the process development and implementation effort, it is time to reduce the key business metrics to tools that can be monitored easily and regularly. They also should be reduced to their most basic format, which usually means they fit on one letter-sized sheet of paper. These metrics should be established and be publishable at the push of a button. It may be even more effective to have them maintained in real time. That way, the key senior managers will be able to review the dashboard of key metrics whenever they want. Implementing systems that can be randomly audited means that subordinates have no real ability to conjure up misleading statistics. A very simple analogy to keep in mind is that no matter how complex an airplane may be to operate, the key statistics are monitored by the flight crew with a simple scan of a few key instruments that provide real-time raw data. With the proper scan, it is difficult for the crew to lose their situational awareness. Managing a business should be viewed in a similar fashion.

Adapt—Don’t Hold Tight to the Original Plan if It’s Not Working

Business managers must adapt to their environment. This should be distinguished from a practice of constantly changing course to hit newly identified milestones. With a disciplined approach to identifying business fundamentals and the key metrics for the business, the most effective leaders are able to stay focused. But when changes occur in the key fundamentals that impact the business, the best leaders and managers are able to assess the situation and make appropriate changes in a timely manner. In this way, no one is tempted to stay with a business plan that simply is not right for
the market conditions. The usual way to maintain this balance is to have a regular practice of retaining qualified independent directors on the board. Typically, they are most effective at keeping the business plan in mind while assessing management’s current activities. That way, deviations from the plan are easier to spot. Independent directors typically do not have enough contact with management or employees to become enamored with a particular course of action that is off plan or has not been fully vetted.

Time management is critically important, because it is one of the key factors that we have little control over. There are only so many hours in each day, and this provides an important constraint that must be managed. But one other important aspect of time is that it is far easier to make a course change when one has sufficient time. It is analogous to a journey between two points: if one discovers that he is off course early in the journey, he has adequate time to make a slight course adjustment and still reach the objective. But if one discovers that he is off course and should already be at the objective, it will take a relatively radical course adjustment to reach the objective. Thus, monitoring one’s progress to objectives is critically important. By implementing a dashboard, management is able to detect slight course deviations early and therefore has time to consider appropriate responses and implement them with little disruption to the enterprise.

**Be Decisive**

All stakeholders must be decisive. Whether they are owners, managers, or creditors, it is important to take action when it is time to act. The important issues must be fully analyzed and understood, but once that thorough analysis is complete and the next steps are identified, those steps must be taken in a decisive manner. It is human nature to have a comment about a particular course of action or a policy. But there is an appropriate time, place, and manner for that commentary to occur and be received. Once that time has passed, it is time for action. The most effective leaders will be able to implement change while still maintaining the loyalty of their team.

**Reasons Why Turnaround Experts Can Help**

It is sometimes very helpful to retain turnaround advisors to assist with the various steps in the process of addressing an underperforming company. One important distinction between turnaround advisors and general management consultants is that they are not sidetracked by the various activities that may be going on around a distressed company. For example, collection lawsuits can be distracting. Qualified and experienced turnaround advisors understand the context in which collection lawsuits exist and have numerous tools available to address the lawsuits and minimize their impact on day-to-day business operations.

Another characteristic of qualified and experienced turnaround advisors is that they are accustomed to managing employees who are preoccupied by concerns over the loss of their jobs due to a business failure. Assuming that the facts support the restructuring plan and the restructuring plan will be feasible, then the turnaround manager should be able to keep employees apprised of progress on a regular basis. This holds true for all stakeholders, but typically the employees are necessary for implementing the turnaround plan, and when they are distracted, they tend to be unproductive. It is a turnaround manager’s experience in these situations that make him particularly effective in managing employees through a turnaround process.

Another distinguishing characteristic of qualified and experienced turnaround managers is that they understand the concerns of equity owners, particularly professional owners such as PEGs. One common concern among portfolio managers is that they have many portfolio companies to address, and they need to be efficient in allocating their time. It is highly unproductive for a portfolio manager to get stuck managing the day-to-day details of a comprehensive restructuring process. Qualified and experienced turnaround managers are able to produce mutually agreeable reports that allow the portfolio manager to know precisely where the company is in its turnaround process and to provide timely and accurate reports to stakeholders. Typically, these reports are the same ones that will be used to keep other stakeholders, such as senior or junior creditors, apprised of the company’s progress.

Managing in a crisis environment is difficult, and it takes experience to perform competently. There are many different business disciplines that are in play. For example, there typically are complex finance and accounting questions. Understanding these issues involves an understanding of the written agreements between the parties and the legal rights and remedies embedded in

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the agreements. They also involve a deep understanding of negotiating strategies and the tools that are available to implement an effective strategy. Too often, inexperienced executives believe that they have no arguments that are persuasive in convincing stakeholders to allow a turnaround process to be completed. Also, there are difficult questions regarding the incremental value of going through a restructuring. Many times, the company will have to be extremely persuasive in fashioning and delivering a pitch that explains the benefit of a restructuring. These pitches typically involve all facets of the business, and it is important that the person delivering the pitch have command of all aspects of the business that may come into play.

Experienced turnaround professionals remain objective throughout the process. It is critical to maintain perspective on the situation and know when to push forward and when to retreat. Sometimes, incumbent management can become blinded to the company’s weaknesses, and they simply refuse to believe that these weaknesses exist. To the outsider, the key to effectively turning a business around is to address the weaknesses, not ignore them. But at the same time, it is important to provide solutions while addressing the problems. The turnaround professional adds great value to the process because it is far easier to maintain perspective when one is objective.

Turnaround advisors can be a very effective resource for business owners and managers. It is never too early to contact a turnaround professional, but there are times when it is too late. Generally, a qualified and experienced turnaround professional will fashion a solution that is tailored to the circumstances. If the business has not reached a point of complete crisis, the turnaround professional typically will assist with implementing the necessary process change over the time available, slowly but consistently changing the business’ course. However, if the situation is dire, the turnaround professional is the only one capable of managing the company and the many issues that will be impacting the company’s prospects.

PEG managers can address potential or actual problems in their portfolios through discipline and dedication to the outcome. However, when that is not enough, the professional portfolio manager should seek qualified and experienced turnaround assistance at the earliest opportunity.

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The Role of the Customer in Turnarounds

LOWELL C. WALLACE

The world of turnarounds is one of extremes. At one end of the spectrum are the salvage operations where wrecked businesses have their few remaining assets sold off in hopes of getting creditors a few pennies on the dollar. At the other, less-populated end reside true resurrections where businesses are snatched back from the brink of extinction and returned to health. The place where any given turnaround project lands on this continuum is often the result of support from a group that is under-appreciated and under-utilized in turnaround work: the customer.

The simple truth is that without customers a business is merely a collection of “inert” assets. Without customers, the warehouses, server farms, factories, lines of code, delivery vans, intellectual property, and piles of raw materials sit there, their value eroding. They are not what the business is all about. They are simply tools to attract revenue. That’s why a growing number of very successful businesses own no factory at all and contract out the manufacture of the products they sell. They know that the true worth of a business is found in its customer relationships, not in its bricks and mortar.

In fact, customers actually create a business because they are the sole source of revenue. A business without customers isn’t a business at all. It’s a hobby. Think of customers as “generator” assets because they are the tiny springs from which cash flows. Without them there is no revenue stream. Also, they need to be profitable customers or there is no profit. A business that has its customer base overrun by the unprofitable is destined for the salvage yard. As an example, using larger and larger discounts to hang onto these customers merely speeds the trip to the final destination.

Customers are the only group that gives a business its intrinsic value. Without truly understanding them, no turnaround effort can bring a company back to life. It is important to determine who the customers are (or who they were), why some have left, why others stay around, and what the business must do/say/pledge to get them to continue as customers.

THE CUSTOMER CARE PARADOX

It is an interesting paradox that the customers, the only group that can return a business to long-term health, are among its most abused stakeholders when a company slips into distress. This abuse can take several forms:

- As a business sours, quality of the product or service suffers, prices rise, and delivery dates are missed. Customer service like that never wins a J.D. Powers Award and...
drives many of those little cash flow generators to the exit.

- In an effort to stay afloat, communication and sales budgets are slashed. Contact with the customer slows to a trickle. Their primary sources of information become rumors (true or not) and alarming press reports. Customers crave certainty. A business in distress provides little.

- Just when the customers’ support is needed most, the focus shifts from trying to keep them happy to trying to get them to pay faster. As they hear more frequently from Accounts Receivable than they do from Sales, it’s no surprise that they defect to competitors at an accelerating rate.

Some of this is intentional, but most is not. In total, the only sources of revenue for the business are treated rather rudely. But this worst-case scenario need not be the epitaph of every distressed business.

If one employs the customers as tools to turn around a crumbling business, the odds are much better that it can be returned to health. Even if it is not ultimately saved, its value can be increased to the benefit of its creditors. To do this takes a marketer’s perspective, a skill set and experience not often found in the typical turnaround team. The marketer’s perspective is one that eagerly takes on the role of ombudsman for the customer: one who understands their needs and strives to satisfy them within the confines of a distressed environment.

How a turnaround marketer approaches saving a troubled company is unique in the turnaround world.

THE ONLY 3 PATHS TO GROWTH

There are really only three ways to improve earnings and grow a business:

Path 1: Find more customers.
Path 2: Sell customers more.
Path 3: Make a greater profit on what you sell them.

There is no number 4. Everything else a business does is just a strategy/tactic/tool to move along these three highly interrelated and interdependent paths. As examples:

- Raise prices? You’re heading along Path 3, but may be backtracking down Path 1.
- Develop new products? Path 2 and sometimes Path 1.
- Cut production costs? Path 3 again.
- Open an overseas market? Path 1.
- Add service after the sale? That’s primarily Path 2, but can really speed the journey along 3. (See exhibit.)

<table>
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<th>Impact of typical Strategies/Tactics on progress along the paths</th>
<th>Path 1</th>
<th>Path 2</th>
<th>Path 3</th>
<th>Notes</th>
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<tr>
<td>Develop new products?</td>
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<td>May add customers but can be costly.</td>
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<td>Cut production costs?</td>
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<td>Can attract/sell more if reflected in pricing.</td>
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<td>Open an overseas market?</td>
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<td>Add service after the sale?</td>
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<td>Can be win/win but may lower profit.</td>
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Key: Positive Progress 📡 Potential Decline 📡 Caution: Possible Advance or Decline 📡
The same applies to turnaround work. Unfortunately, a disproportionate amount of time and effort is spent on Path 3 (making a greater profit on what is sold). Costs can be cut, but only so much. Injections of new capital can keep the doors open for a while longer. But unless there is real effort put behind finding new customers and selling more to every customer, the inevitable liquidation is merely being postponed.

The first task of the turnaround marketer is to determine if there is any chance to save the business by enlisting the help of its most abused of stakeholders. It is important to quickly assess just how much abuse customers have suffered and whether there is any hope of redemption. In extreme cases the only hope of saving the business may be to build a completely new customer base or to offer very different products and services to those customers that remain.

KNOWING THE CUSTOMER

A savvy marketer will tell you that customers exist in three basic flavors: Loyal, Neutral, and Vulnerable. Imagine that they are your customers or the customers of one of your portfolio companies.

The Loyal Customer

These are the folks that are most tightly bound to the business. They may be the 20% of customers who generate 80% of the revenue. They are the ones who will forgive you if you screw up once, or maybe even twice. They like you; they understand you; they believe that what you sell them or do for them has value or is important to them. When you think of Loyals think of Harley Davidson tattoos on the arms of 40-something orthodontists.

The Neutral Customer

These are the folks that are most tightly bound to the business. They like you and what you offer but aren’t ready to die for you. They just don’t think about you all the time. The good news is that you have made their short list. For an example of neutral customer behavior, just think about orange juice. Spend a Saturday morning in front of the refrigerated case in a supermarket and you’ll see a lot of people shopping the orange juice section by staring at the price channel stickers. Tropicana? Minute Maid? Florida’s Natural? They’ll buy the one that happens to be two for $6.00. Brand doesn’t matter to Neutral orange juice consumers because it just isn’t a super “brand-critical” category for them. They might prefer Tropicana and hope it’s on sale when they visit the store. They might stock up if it is, but are just as likely not to. Over time you may be able to transform some of them into Loyals, but a few will drift into Vulnerability at the same time.

The Vulnerable Customer

Your grasp on these folks is tenuous at best. They may bolt at the drop of a hat, or a competitor’s coupon or more favorable credit terms. Screw up with this group and there are no do-overs. Your entire category may not be that important to them. They probably have a set of equally acceptable brands and buy whatever is on sale. But unlike the Neutrals they are looking to pare down the list. For example, consider the purchasing agent who buys widgets. Because there is no such thing as a totally rational sale, whoever gets the next order for widgets may hinge on who provides the best golf outing and dinner. That won’t be the stated reason that you get thrown under the bus. It will have something to do with a more tangible feature such as color selection or delivery date. Businesses cursed with a high percentage of Vulnerables are constantly searching for new customers to replace the departed. Retail bankers have been creating legions of Vulnerables over the last 20 years as fees escalate and customer service evaporates. Consolidation, interest rate promotion, on-line banking, and the lure of free checking have put banking Loyals on the endangered species list for an entire generation just beginning financial adulthood.

Think about what happens to the three types of customers as a business slips into distress. It is important to first determine if a business screwed up and drove customers away or if the business was asleep at the switch as customers were wooed by a competitor. Without conducting loyalty research, it is often impossible to determine 1) what brought the business to the brink, 2) if the tipping point to oblivion is approaching, or 3) if the business can be saved at all. Without an intimate knowledge of the customer relationships, it is easy to misdiagnose what brought on the distress.

One last point about customer loyalty: Don’t confuse frequent customers with Loyal customers. Just ask Starbucks. Frequent (read that daily) customers have
bolted for the Golden Arches and Dunkin Donuts as latte prices climbed and the economy soured. If all the Starbucks' customers had been Loyals, baristas wouldn't be hitting the unemployment line.

THE DAISY CHAIN OF DESTRUCTION

Let's assume for a moment that you have a business that has begun its descent into distress. Earnings have begun to shrivel, and the call goes out from the Boardroom to improve them right away. Managers will immediately begin to attack the cost side of the earnings equation by taking out the budget knife. It is the instinctive reaction by the majority of managers because it's relatively quick and fairly easy. But if no attention is paid to increasing revenue by following one or more of the 3 Paths, bad things can start to happen. At first they may be imperceptible, but given enough time they can gather an unstoppable momentum.

Whenever the order goes out to cut costs, the Marketing Department is usually the first stop. Advertising expenses are easy to reduce. Just cancel the insertion order. Postpone the new ads. Drop the next quarter's promotion. Even businesses that have no marketing department do it. Industry shows are skipped. Trade association memberships lapse.

Next the budget knife heads over to the Sales Department. T&E budgets get slashed. The head count is reduced as the organization is reconfigured. Costs are cut and earnings improve, maybe, for a little while, hopefully. If not, more programs are cut and sales decline further. The Daisy Chain of Destruction is in full swing.

Soon the big knife heads to Purchasing where cheaper (read that inferior) raw materials are sourced, and corners get cut. Manufacturing processes are changed or accelerated. Want an example? Look no further than Schlitz. If you weren't of legal age in the 1970s, ask a beer drinker who was. At one time Schlitz was the #2 beer in the United States. But they changed to a high-temperature fermentation brewing process to cut costs. As an unintended consequence they wrecked the taste, and pretty much killed the brand.

As the budgets are trimmed things may look OK. Costs are lowered; earnings hold or maybe even be up. But remember those hundreds, thousands, or millions of little springs from which cash flows? You know, the customers. What about the impact on them?

It's not unusual for a lot of the Vulnerables and even some of the Neutrals to head down the street when they sense changes in the wind. They head off to find an acceptable competitive alternative. It can even be an unconscious desertion. They just don't see any of your ads anymore. They don't see your sales manager as often. They just don't think about you. Or in the case of the Schlitz drinkers, they don't like the way you taste!

Interestingly, Pabst has re-launched Schlitz in bottles proudly touting the 1960s recipe—for the handful of beer drinkers who still remember it. Oh, by the way, Pabst doesn't own a brewery.

Remember that golf-loving purchasing agent? He now buys from one of your competitors, even though their rep is a tennis player, because he really liked the regional sales manager you canned during the most recent restructuring to improve earnings. The competitor saw an opening and pounced.

If the first-round cuts don't work, earnings deteriorate further, still more cuts are made, and customers hear from you even less. Oh, sure they get a fax or an email every once in a while. Or they may get a call from the new outbound telemarketing service hired to replace the old (and expensive) internal sales team. But those at the new call center aren't as knowledgeable or empowered to make real commitments to customers, so sale-closing rates drop.

The daisy chain of value destruction grows in length. The number of customers heading for the hills climbs and revenues plummet. More costs are cut to improve earnings and quality suffers. Still more customers defect, and those that remain are starting to pay more slowly because they know you’ll ship anyway because you need their business no matter what the cost. Rumors about your long-term prospects (or lack thereof) begin to swirl through the trade propelled by competitors who really don't want to say anything bad (wink, wink) but feel it is their duty to let your customers know about the trouble you are having.

Pretty soon all that is left is a shrinking group of Loyal Customers who have stuck with you even as things got tough. There are also a few Neutral and Vulnerable stragglers who just aren't motivated enough to change their ways—yet.

But wait. Suppose for a moment that we don’t play this game all the way to the final whistle. Instead let's jump back in time to the point where the first earnings
hiccup occurred. And rather than just taking a chainsaw to the easiest costs to cut, let’s think about the revenue side of the earnings equation. Think growth and the 3 Paths to achieve it.

You’ll be entering a realm where the skill set required is not usually found among those frequently involved in turnarounds: law firms, operating consultants, and accounting practices. It requires a depth of understanding of the primary tool used to move down the 3 Paths of growth: the brand. It also requires brand-builders with experience in the high velocity, resource-lean environment of turnaround work.

Most traditional marketers, however, are ill prepared to operate in a turnaround environment where time is of the essence and resources are limited or nonexistent. Success in turning a business around requires the ability to bring a fresh set of experienced eyes to the table to connect the dots in new ways. It requires an optimistic outlook that focuses on growth rather than just on stopping the bleeding. It requires the ability to work with speed. It is an environment that many traditional marketers find uncomfortable if not paralyzing. It requires a Turnaround Marketer.

The first step you’ll need to take is to get an honest handle on the customer base and its segmentation. If customer loyalty research exists, great. If not, take some of those limited resources and get it done. Ten years ago this could have been an expensive and time-consuming proposition, but not today. Now there are some real smart, real fast people who can produce quality loyalty segmentation research quickly. They cut their teeth, so to speak, on time-pressured acquisition due diligence work. Now they are applying that same swiftness to turnaround projects.

Once you get a real handle on the customer base, the relative size of the three loyalty segments, and what motivates customers to buy from you, you can set about following one or more of the 3 Paths to revenue growth using the only real tool you have: your brand.

While there are scores of definitions of a brand, the turnaround marketer hangs his or her hat on this simple statement: The brand is the one asset that can generate cash flow. At its core, a brand is a financial transaction where a business exchanges a good/service/IP for a customer’s cash and both parties receive value. It is the tool that starts and sustains the flow of cash. The trick in the turnaround arena is to increase the number or frequency or size of those brand transactions without spending bags of money to do it. Let’s take a look at a few examples.

**PATH 1: FIND MORE CUSTOMERS**

When we need an example of how attracting more customers can be done by gaining an intimate understanding of their needs and wants, we always come back to the turnaround of Chrysler under Lee Iacocca. Many view this rescue as a fantastic piece of financial engineering built upon the Federal loan guarantees that gave the company a shot at survival. And while that is true, equally important was the re-engineering of the product offering to attract new customers. From the ashes of Chrysler rose the minivan and the K car, both of which revolutionized the car business. By the way, they even went so far as to produce the Voyager and Caravan on a stretched K car platform. Remember: hold down costs at all costs.

Another example from a few years ago involved car batteries. While many people know Johnson Controls Inc. (JCI) for its building and HVAC control systems, not so many know about its battery division and a significant amount of turnaround prestidigitation that took place in the 1990s. So let’s hop in the time machine and start at the beginning by heading back to the Eisenhower years. In the late 1950s, a company called Globe-Union invented the thin-walled polypropylene battery case, a breakthrough in automotive batteries because it was lighter and stronger than the hard rubber cases used previously. In 1967 Sears began to use this technology in its DieHard battery. By 1971, Globe-Union was the leader in replacement automotive batteries with sales climbing past $100 million a year. At about the same time, JCI began to diversify beyond its building and energy control core businesses. In 1978 Globe-Union merged with Johnson Controls and brought with it its largest customer: Sears.

For the next decade things were pretty good. However, the battery group was the least profitable of the divisions of an increasingly diversified company that included automotive seating systems and plastics. In 1991, JCI attempted to sell its battery division without success. In 1994 the roof fell in: JCI lost its contract for the production of the Sears DieHard battery to Exide.

While JCI reduced manpower and cut costs to try and stop the bleeding, it also decided to attempt what for
the time was a fairly radical move: replace the customer. They assembled a SWAT team of internal people and external resources willing to work in a high-pressure, limited-resource environment. Over the next three years they attracted new customers and end users through a combination of new products, new brands, innovative marketing programs, and just plain hard work. Contracts were signed or renewed with AutoZone, Wal-Mart, and Interstate Batteries, the largest battery distributor in the United States. In late 1997, JCI’s battery group signed a contract to supply a top-of-the-line premium battery to a new customer: Sears.

**PATH 2: SELL EACH CUSTOMER MORE**

This path played a big part in the JCI battery group story, because when faced with the loss of a big customer, a natural place to turn is your remaining customers. But it poses some very real challenges, because other buyers know what a blow the loss of a major customer is. The remaining customers now believe they have more control over you and are inclined to do some nasty stuff, like trying to exact some pricing concessions or exclusivity arrangements. Not that they are bad people. They are just businesspeople who happened to wake up one morning and found they’re a much bigger fish in a smaller pond.

A natural reaction by a distressed company is to respond to the foot-on-the-throat pressure by doing whatever the customer wants. And that might have been the reaction of the battery group had it been a stand-alone company. Some like JCI hold their ground and respond by finding ways to sell the remaining customers more. They created a continuous stream of new products, new brands (like licensing the Eveready and Energizer brand names for car batteries), and new marketing ideas.

In the turnaround effort, a series of innovative new products were produced for the automotive market and specialized markets such as marine and racing. Low-cost, customer-specific sponsorship and field marketing efforts were developed and offered to customers. In fact, each customer pitch included a presentation of fully fleshed out promotion and marketing ideas specific to that customer as well as private-label branding ideas. (Not often that you see private label and branding in the same phrase.) All of these efforts were aimed at getting customers to buy more. And along the way they bought products that generated greater profit.

**PATH 3: MAKE A GREATER PROFIT ON WHAT YOU SELL THEM**

All the brands of products or services available in any given industry or category occupy specific places on a price continuum. At one end (or the bottom if you like) is the really cheap stuff. At the other end (or the top) sit the ultra-premium brands. The profits made on each pretty much follow the same linear relationship. Timex has to sell a whole lot of $19 wristwatches to match the profit generated by a single TAG Heuer Chronograph.

With imagination you can sometimes get your customers to trade up to the high-priced and higher-profit end of the continuum. And sometimes you can’t. One of the best examples of the former is Toyota’s creation of Lexus to take its Loyals up the profit and price ladder. An example of the latter is found with Smirnoff and its decades-long inability to move its customer base upward. At one time it was the top rung of the premium vodka ladder, only to get eclipsed successively by Absolut, Skyy, and Grey Goose while its own repeated attempts to launch an ultra-premium version of itself failed with every consumer segment. But the fault wasn’t really Smirnoff’s. Vodka is a category in which brands composed of products with ever-increasing quality and price levels just don’t seem to work. Unlike Johnnie Walker Scotch Red, Black, and Blue, the “better” quality brethren of Smirnoff such as Smirnoff Silver and Smirnoff de Czar never gained traction. Diageo, the owner of Smirnoff, recognized this too as it joined in the bidding for Absolut before withdrawing to purchase Ketel One.

Johnson Controls, on the other hand, succeeded on the More Profit Path by focusing its new-products effort in two directions. One was creating value-added enhancements that would command a higher price point and greater profit. The Security battery was one such up-market effort. It incorporated a computerized security system for the vehicle within the battery case, and the simple act of replacing the battery gave the customer state-of-the-art anti-theft protection.

The second avenue the R&D folks pursued was to make every battery the best battery possible, not the cheapest. It is interesting to note that the earlier-mentioned JCI battery that first got back into Sears was the premium DieHard Gold, not a discount-priced piece of junk. At a time when it would have been easy to cut both costs and prices, resulting in a cheaper but inferior
product, JCI tacked in the other direction and headed up the quality (and profit) ladder.

The 3 Paths are interconnected and interdependent. Heading up on one can force you back down another. There are a number of case studies that show what can happen when you try to follow Path 1 to more customers by attracting them with something that you make less profit on. An effort that takes your brand down-market in hopes of attracting new customers can be expensive and painful. If you ever have the chance, ask a long-time Cadillac employee about the Cimarron and look for the very pained expression on his face. Granted, part of the reason for its introduction was to meet the increased CAFE standards for company-wide fuel efficiency, but it was arguably a response to low-priced import compacts from manufacturers such as BMW. The Cimarron missed the quality mark at almost every turn and is credited with significantly tarnishing the Cadillac brand image. Customers could see the Chevy Cavalier lurking beneath the Cadillac badge and a sticker price of $12,500. That's $30,000+ in 2009 adjusted for inflation and twice the price of the Cavalier.

3 PATHS AT ONCE

It is also possible to travel all 3 Paths simultaneously. Such was the case with Titan Machinery Sales.

Titan Machinery Sales is a regional machine tool distributor selling precision grinders made by Japanese manufacturers. It also has a significant business in the purchase of used machines that it refurbishes, re-engines, and resells. A third, smaller part of its business is the design and manufacture of cooling systems for the machine tools it represents.

In 2007 Titan applied to the Turnaround Management Association Chicago/Midwest Chapter for pro bono turnaround assistance as the result of a significant defalcation and fraud by its minority shareholder. The company was severely delinquent with its most important machine tool supplier and its banks. In addition, its distress was having a very real impact on its sales and marketing efforts at a time when they were needed most. Titan was in very real danger of closing its doors.

The pro bono team assembled included operational management and debt restructuring expertise, as most turnaround teams do. Unique to this situation was the specific request for sales and marketing assistance. Following the introductory meeting in Titan's offices, the team took a tour of the manufacturing and engineering facility. It was there that the opportunity to walk 3 Paths at once became clear.

While watching a large bench grinder being refurbished, the marketing team noticed a cooling system sitting off to the side. Such a system consists of a large tank, filter media, and pump assembly. To cool the grinder cutting heads, a coolant is continuously flushed over the object being precisely ground. The coolant fluid then flows through the coolant system, where it is filtered to remove metal shavings and any contaminants. Clean fluid is then returned to the cutting surface.

Upon finishing the tour, questions about the coolant system included:

- Why was it powder coated, not painted?
- Since there isn't a label, what is the system called?
- To whom is it sold?

The answers began to form the basis for a “brand” of coolant systems and an opportunity for growth.

- It is powder coated instead of painted (like the competition) so that it never rusts through.
- The label is just a mailing label behind the access panel so the owner knows who to call to get more filters, and the systems really don’t have a name other than Titan.
- Titan sells systems direct to one of its grinder manufacturers, which resells them as its own product.
- Titan occasionally sells systems to other machine tool distributors around the country.

In a nutshell, the product was unbranded, offered superior performance, and was primarily a private-label product subject to the ordering whims of a reseller. From that beginning the team helped Titan create an additional coolant system line that carried a “no rust through” guarantee, had a higher price point than its current line, and could be mated to a wide range of machine tools, not just those sold by Titan’s grinder manufacturer. It was given its own brand name, a different color, and a higher price point.

The benefits to Titan were:

- A higher profit product line (Path 3).
- A new brand to offer to other distributors across the country for a wider range of applications (Path 1).
• An add-on sale to go with the refurbished machine tools (Path 2).
• The ability to continue to supply private-label product to their primary grinder supplier. (No back-track down Path 1).

In summary, Titan was able to travel all 3 Paths at once and experience a dramatic increase in morale among its personnel in the face of dire business circumstances. Alterations to the existing products and the production of limited marketing support efforts were very modest expenditures so as not to compound the company’s distress. Yet they were new, fresh, and gave the team something exciting to share with customers, new and old. By combining marketing with the operational and debt management skills of the other team members, Titan was able to rebound from a loss and show a significant profit the following year. For its work, the Pro Bono Team received a 2008 Turnaround of the Year Award from the Turnaround Management Association.

The next time you are faced with a turnaround situation, don’t assume that growth is impossible. With a better understanding of the customer base and the help of a turnaround marketer, greater value might be realized. Think salvation instead of salvage.

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Why I Stopped Drinking Milk: 
The Impact of Commodities and Currency Pricing on Restructurings

Baker A. Smith

“...these wheat prices are killing our company!” exclaimed the chief financial officer of a multimillion-dollar food products business. As I looked around the conference room, each board member nodded his or her head gravely. This was a company that had been in business for over 50 years. How could commodity price fluctuations be responsible for its dire situation?

Many companies whose cost of goods includes a substantial percentage of commodities simply pass along to customers any price increase. When the company is unable or unwilling to pass along the price increases, cash tends to become tighter, resulting in an eventual liquidity crisis.

However, the last few years have witnessed an almost unprecedented run-up in the price of many raw materials. For example, wheat prices were practically static for many years, hovering around $4 per bushel from 2002 until 2006, when they began a steady climb which peaked in 2008 around $15 per bushel before the price partially dropped back. It is noteworthy that other grain prices increased dramatically, as did virtually every major category of commodities: petroleum, petroleum-driven products like plastic, gold, and metals such as steel and copper.

So why the doubling, tripling, and more of wheat prices specifically? The causes were both man-made and natural. While there was some talk at first of decreased crop yields and increased worldwide demand, farmers soon increased production accordingly. However, one of the most obvious man-made causes was an increase of government support for ethanol as an alternative to gasoline. When farmers chased the money by switching to corn from wheat production, wheat production was reduced, at least at first. Even steady demand would have driven up prices. Also, when one grain price increases, it tends to pull up other grain prices with it. For example, during this 2006 to 2008 period when corn doubled in price, both wheat and soy prices showed similar increases.

WHY INFLATION IS BIG TIME EVEN IN A RECESSION

Looking back over the years, various commodities, including gold, oil, grain, and metals, have had their individual ups and downs. However, the most recent periods have witnessed simultaneous and substantial price increases in all these categories. For example, oil quadrupled in price and is unlikely to return to its previous levels.

Business leaders on the front lines of the battle believe they are seeing inflation of commodities prices and a loss of value in U.S. currency. Government officials are loath to admit this.

What’s even stranger is that Federal Reserve policy seems to have ignored its traditional role of fighting inflation. As companies
have struggled with steeply-rising commodities, from the first interest rate reduction of the Bernanke Federal Reserve Board to the present, they have been puzzled by the Board's actions. Although the Board has characterized its actions as fighting recession, the timing of its actions with the successive stock market declines could lead one to suspect the Board was trying to prop up stock prices.

Investors did not agree that lowering interest rates would improve the financial outlook for publicly traded companies, as stock prices have continued their decline to date, losing more than half their value from a 2007 high and hitting their lowest level in 12 years. Along with these investors, Dallas Federal Reserve President Richard Fisher has consistently disagreed with the Federal Reserve Board's rate-reducing majority including Chairman Ben Bernanke and former New York Federal Reserve President (and current Treasury Secretary) Timothy Geithner. The poor stock market results would seem to validate the policy of Bernanke's predecessor Alan Greenspan, that influencing the stock market was to be eschewed by the Federal Reserve Board.

Given the severe recession the nation now finds itself in and interest rates at 0.25%, the Federal Reserve has left itself little room to maneuver without flooding the economy with more currency. Historically, printing more money would further the dollar's slide, thus contributing to more commodities inflation. With 2009 commodities prices only slightly moderating and still above historic levels, business owners view with dread the prospect of additional inflation.

Increases in commodities prices are not always easy to pass along to customers. As the foregoing food company was caught in a vortex of rising wheat prices, its way of doing business for the previous 15 years failed it. The company simply did not have the financial infrastructure to recognize and pass along the price increases. Its financial systems and controls were only adequate for the previous steady state that had characterized wheat prices over periods of years.

When wheat increases were followed rapidly by additional increases, there were suddenly too many pieces moving, both internally and externally, which had previously been static assumptions. As a result, it was necessary to work with the company to create new models that helped management track and control variables and capture costs in their customer pricing.

In addition to the inadequacy of their financial systems and controls, the company needed a new approach to management. As a large family-owned and run business, sale of the business was not a desired option. Necessary changes had to be executed while retaining many family members in key management roles. Critical changes included creating a more functional management organization that reinforced and supported the way the company sourced commodities, produced food, and serviced customers. Once the new organization was agreed to, management slots were filled from within and outside the company. Severance arrangements were made for redundant positions, including several long-time employees.

SELL MORE, LOSE MORE

In conjunction with the outdated management organization, this food company suffered from poor communications. After 15 years of the same people doing the same job in the same way, key managers engaged in minimal communication since they assumed everyone already knew what was needed to do their job. Unfortunately, this theory broke down when frequent price increases became the norm. Critical information fell through the cracks that top management needed in order to make key marketing and operating decisions. For example, wheat purchase contracts were agreed to without checking on the availability and timing of cash, thus exacerbating a tight cash situation. Terms of customer contracts other than price, which nevertheless affected overall delivered costs, created a negative cash flow situation. The more finished food goods the company sold, the more money it lost.

New procedures and checklists were put into place along with the new management team. In addition, management held regular meetings and opened the meetings to employees who were previously assumed to know what they were doing. The purpose was to keep affected personnel apprised of what was happening and solicit their input. Daily cash meetings were held to discuss cash availability and to prioritize and determine the critical payments and raw materials for that day and future days.

As the company edged back from the brink, rising wheat prices continued to plague its efforts. In order to avoid the higher additional costs of buying wheat on the spot market, the company traditionally bought futures contracts. These contracts locked in prices, but except for a small upfront deposit, typically did not require supplier payment until delivery. Further, customer contracts typically calculated the price based on futures prices, so there was not a penalty to the company if the
price dropped. However, a seldom-exercised call provision of the futures contracts surprised the company.

The contracts provided that wheat price increases above set levels called for additional deposit amounts. Given the unprecedented rise in the price of wheat, these deposit calls totaled millions of additional dollars that the company simply did not have. Fortunately, the company’s lender was willing to cover the calls and add the cost to its existing loan. (Unfortunately for its competitors, other lenders around the country were not comfortable with these cash calls and were unwilling to advance much-needed funds.)

The decline in the value of America’s currency and inflation of commodities prices were key drivers of turnaround engagements by several other industry clients, although inflation’s impact on the business varies from company to company.

WHY COMPANIES DON’T RAISE PRICES

“The lender is over-reacting. They just don’t understand our business,” explained the CEO of a plastics business. Plastic is a good example of numerous products for which petroleum is a key component. When oil prices increased, this multimillion-dollar injection molded plastics company began to experience cash shortages. However, when modeling the cash flow forecast over the future weeks, it became apparent that the company would hit a wall. Then it was the company’s turn to react.

Research showed the company had no-customer-price-increase policy. Management was holding its customer prices steady while absorbing increased commodities costs. They argued that they enjoyed long-term relationships with their customers and these customers were resistant to price increases. Unfortunately, the company would not be able to serve customers at any price if it ran out of cash and ceased doing business.

In a consolidating industry that is undergoing price pressure, there may be no room to insist on higher customer prices. In these industries customers may be able to shift to a lower-priced competitor, with the client losing revenue and ability to cover overhead. The only way the client can regain revenue in this scenario is to steal market share from another creditor by price cutting. If the price is so low that the client operates at a loss, it will eventually run out of cash and go out of business.

However, this injection molded plastics company was not in such a scenario. In fact, it controlled almost 90% of the market for this particular product. Under these circumstances, it became obvious that the company was setting the industry price and competitors were following this lead. With encouragement the company became more secure in its view of the business, realizing that price increases were a matter of survival.

Nevertheless, the company was still reluctant to proceed with raising prices. The management simply did not have the stomach for such difficult and unpleasant conversations and did not want to ask longtime business friends for a price increase.

“After receiving numerous price increases from our suppliers, we are reluctantly increasing our prices effective January 1,” read a letter from a supplier to the plastics company. Realizing that virtually every business owner receives price increase letters like this from suppliers, the plastics client decided that customers would not be at all surprised to receive such a notice from them. The customers were all well aware of what was happening with oil prices. By writing a similar letter and having management fill in the appropriate blanks by product category, the management quickly brought smaller customers onboard. A discussion script was prepared for major customers and special long-term relationships.

WHY SOME COMPANIES CAN’T RAISE PRICES EVEN IF THEY WANT TO

Sometimes rising commodities prices can whipsaw a company, especially if different commodities affect a company in different ways.

“Our company had been doing fine for seven years, but oil prices and food prices are killing us and our customers,” stated the chief executive officer of a nearly billion-dollar food distributor. “Will you help us?” The chief financial officer and the chief marketing officer chimed in their agreement. The company was bleeding cash faster than it was able to bring it in. After years of steady state operations, twin commodity price increases created a perfect storm.

Sales to several multimillion-dollar revenue restaurant chains had fallen across the board, as first rising food prices and then declining customer counts hammered restaurant sales. Food prices were driven up initially as grain prices rose for wheat, corn, and soy. Although wheat drives bread prices, grains are also major feed items for many of the protein products sold in restaurants like milk, beef, chicken, and pork, so those prices went up also. Plus, grains, especially corn oil and soybean oil, are an ingredient in

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many processed foods used in restaurants such as flavored drinks, dressings, and margarine, driving those prices up too. As the economy worsened, many restaurant patrons moved downscale in search of lower prices, leaving the company’s customers short as much as 20% in sales.

Falling sales to these restaurant chains meant the company’s trucks were covering the same routes and the same distance, but with 20% fewer goods sold per truck. Unfortunately, rising oil prices drove fuel costs to double, triple, and almost quadruple recent fuel price levels.

Why didn’t the company pass along the fuel price increase to its customers? Unlike the wheat-based food producer client, fuel surcharges were not the norm for food distribution. Customers fought fuel surcharges and would negotiate to split the difference. If the company had the contractual right to impose the full pass-through of fuel costs, many customers refused to pay.

Significantly, when customers agree to pay the full fuel surcharge, there is a very expensive cash lag common to the transportation and trucking industries. The time lag occurs between the time the company recognizes and pays the increased fuel costs and when these costs are billed to and collected from customers. The billing terms to fuel providers are shorter than the total time to collect from customers. Wouldn’t this be a wash as the company gets into the cycle? Regrettably, the steep slope of the fuel price increase forced the company to advance ever larger amounts of cash.

Many of the company’s restaurant customers were unable to sustain 20% revenue losses and closed their doors, leaving the company with uncollectible receivables on top of its other cash demands. Since the entire food distribution industry has been affected by the same factors, the industry is undergoing a consolidation, with the client liquidating some of its assets and selling other operations as a going concern.

Rising fuel prices have combined with the distressed economy to affect a company from another industry, a multimillion-dollar recreational vehicle (RV) dealer. Like the rest of the RV industry, this company was suffering from a 50% decline in sales.

While the company’s customers were typically high-net-worth individuals who one would not expect to be put off by high fuel prices, it turns out that a $1,000 fill-up takes the fun out of recreation when the customer is accustomed to $250 fill-ups. To survive, the RV dealer cut overhead and operating costs to bring them in line with the new 50%-lower level of sales.

While most of the above companies were able to survive, or at least maximize realization of value on their businesses, the decline in the value of the dollar and the increase in commodities prices have presented challenges that require far more than simply cutting costs and increasing profitable sales. For several of the survivors it was a matter of timing. Had the turnaround assignment started later, there would probably not have been enough liquidity to keep the company from hitting the wall before the restructuring plan was completely executed.

THE CHEAP DOLLAR IS NOT YOUR FRIEND

While economics textbooks typically discuss the potential inflationary spiral unleashed by passing along price increases, the results are actually much more complicated and much more destructive, regardless of whether the price increases are passed along. Companies are the engines of incomes for consumers as well as the products consumers want. Inflation of consumer prices is only one bad result of large currency and commodities swings. Government officials need to take seriously monetary policies as a public trust when the wrong decision can so suddenly throw entire industries into a tailspin.

No one should think these companies can be fixed simply by passing on price increases. Even if a pricing pass-through can be achieved, there remains the challenge of lag time, side effects, and perceptions outside the company’s control.

Timing is particularly critical in these engagements. Although turnaround consultants would always like to get started earlier, the reality is that private equity sponsors and lenders typically avoid overreacting to the first covenant default. However, the above examples demonstrate how quickly the viability of a company is threatened by these inflationary problems.

The best approach for the portfolio manager when a default occurs will be to determine the key factors affecting the company. If the problems are commodities or currency driven, the portfolio manager should consider accelerating the referral of a financial advisor from the typical, sequenced pace.

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Credit and Liquidity: Where Have You Gone? How and When Can We Get You Back?

ROBERT D. KATZ

Given the life-changing paradigm shift that we are going through now, we are all pondering the questions, issues, and concerns surrounding capital and liquidity. Let me start by throwing out a hypothesis that may give a glimmer of light, even hope, despite the plethora of talking heads on television whose job it is strike fear in all of us so as to sell advertising and make headlines.

The majority of the publicly traded companies have given guidance on their 2008 financial performance and, not surprisingly, most of it is less than encouraging. That the markets recently got all excited when Citigroup recorded two straight months of profits is very telling. However, for the most part, privately held companies that represent the majority of the United States and global economy rarely give guidance until they have to. According to most credit agreements, this is 90 to 120 days after year-end, and with most companies on a calendar year, that would mean they are required to deliver financials between the end of March 2009 and the end of April 2009.

Only then will the public know how these companies, ranging from the local pizza shop up to billion-dollar entities, are performing, though they are not subject to the strict reporting guidelines that apply to those that issue publicly traded securities. Through the early part of the first quarter of 2009, it appears that lenders and equity funds are unwilling to move far from the sidelines.

Toward the end of the second quarter, May or June, investors/funds/lenders (i.e., those in different tiers of the capital markets) may realize that if they have any hope of salvaging 2009, they may have to release into the market a certain amount of funds. Similarly, companies may realize that they have not made any capital expenditures or upgrades to improve productivity and that they too, if they have any hope of salvaging 2009, may need to do so in short order. So late in the second quarter and early in the third quarter, there may be some momentum.

Questions that beg to be asked are, “What are we going to do in the meantime? And if Citicorp was trading at less than $1, Bank of America at $4 to $5, and General Electric at $7 to $8, at the time this was originally written what hope is there for me in the middle market?”

SUDDEN THOUGHTS AND SECOND THOUGHTS FOR YOUR CONSIDERATION

Your current equity sponsors/partners and lender may be the best alternative for turnaround-situation funding to get through these economic times. Reasons:

- Investors and lenders, both first and second lien that have the appetite to fund, have
significantly decreased during the last six to nine months (see Exhibits 1 and 2).

- Market shifts are changing for the benefit of the lenders.
- Appraisals are coming in more conservative than ever.
- There has been no worse time to liquidate in recent memory, regardless of the circumstances and industry.

As one of my competitors said, “I have put down (liquidated) more companies in the last year than I had in the previous decade.”

If you maintain good reporting and communication with your current stakeholders and have a forecast/plan for 2009 and 2010 that is realistic and achievable—including providing a sensitivity case that shows a down-side consideration if certain of your base case assumptions don’t materialize—there is a chance

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**EXHIBIT 1**

Volume of First-Lien Institutional Breaks by Month, 2001–September 2008

![Graph showing volume of first-lien institutional breaks](source)

*Note: *Excludes Delphi’s $2B TL break in March.

*Source: Copyright 2008 Standard & Poor’s, a division of the McGraw-Hill Companies, Inc.*

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**EXHIBIT 2**

Volume and Number of Second-Lien Loans 1997–2008

![Graph showing volume and number of second-lien loans](source)

*Source: Copyright 2008 Standard & Poor’s, a division of the McGraw-Hill Companies, Inc.*
that your funding will be considered. The current
constituency may be more interested in preserving
their investment, collateral, and stake than taking the
chance and letting it dissipate.

Certain business entities including secured and
mezzanine lenders, as well as trade creditors, may con-
sider converting some of their debts and equity. While it
usually is “all about cash flow,” sometimes it’s about not
digging a bigger hole and risking the opportunity to
preserve their investment, collateral, and stake.

This is likely to take a significant amount of persua-
sion, but it is certainly worth considering, especially if
the alternative is to liquidate or shut down the business.

Here are some additional considerations:

- Lay out the alternatives: e.g., liquidation or bank-
rupency will offer a significantly lesser recovery.
- Understand and plan on how many constituencies
  you will have to negotiate with. Certainly to build
  consensus, it is easier to do it with fewer constitu-
  encies than more.
- Outline your proposal. Before you present it to the
  constituencies, review it with your management
team as well as a group of professionals that you
work with (primarily your turnaround consultant
and restructuring lawyer). Rarely will you have an
opportunity for a second bite at the apple.

An Example

An importer/manufacturer had a shaky relation-
ship with its lender. In order to get through its toughest
time of the year, it needed an over-advance that totaled
approximately 4% of the outstanding loan. The com-
pany’s collateral and other reporting systems were
mediocre at best. When company management and the
lender didn’t see eye to eye on things, it made for trying
situations and the lender instituted additional reserves in
a conservative measure.

Executive Sounding Board Associates Inc. (ESBA)
prepared a liquidation analysis that clearly showed that if
the lender liquidated during this time of year and in this
market, it would face a substantial shortfall and writeoff.
Through its plan, ESBA was able to help the company
improve its reporting system so the lender could more
effectively monitor the situation and institute certain
reserves that provided more comfort without crippling
the company. We also helped the company develop both
a base-case forecast and a more conservative forecast that
provided the lender with an additional downside road
map for the balance of 2009. With improved and tight
reporting and incremental reserves in place, it provided
the company with the overadvance it needed, giving all
the constituencies the opportunity for greater success.
While the situation is currently a work in progress, it’s
so far, so good.

PRIVATE EQUITY, DISTRESSED INVESTING
FUND, OR OTHER SOURCES

There is no question that credit and liquidity is
the tightest it’s been, but there is still money out there.
Those with vision who can look beyond the current
turmoil to the future and the opportunistic situation are
not only going to be in a position to produce significant
returns for their investors, but also are most likely to be
the leaders who you want to have associated with your
company. At this point it is so easy to follow the tide,
hunker down, and remain in the bunker. Those who
are creative and searching “outside the box” are usually
the most successful. Searching for and obtaining a
partner who can think non-linearly makes an excep-
tional difference.

In order to be successful in a restructuring of any
type or through a variety of transitions, two of the most
important components are:

- Having the vision to know where you are going and
  what you are trying to accomplish, and identifying
  the potential pitfalls and problems along the way.
- Being able to manage the expectations of all inter-
  ested stakeholders throughout the process.

Through good times and bad, knowing how your
partner(s) will react is critical for both for the imme-
diate/short-term prospects and longer-term opportu-
nities to succeed. There are few things as important
as or more critical to success as having the vision and
determining the critical components necessary to see
the situation to a successful conclusion—especially when
times are tough—and being able to understand and adapt
when the company ranges off the path.

This means associating yourself with parties who
are able to manage through the minefields and, at times,
going out on a limb in a managed way, especially when
others with little appetite for risk and less experience may
not. It is being able to differentiate the ability to manage
stockholders’ and other stakeholders’ expectations versus managing and proceeding for fear of job loss. At times, this can be an extremely fine line. Let me explain what I mean from personal experience.

Two banks each had a $20 million revolver with separate divisions of a particular client, each division with its own set of issues. When these two banks merged, this $40 million loan overnight became one of the larger “rated” credits in this bank’s portfolio. The investment banker hired by the company identified a strategic buyer, and the sale and settlement was planned during the next 45 days.

Every Tuesday, for arrival on Wednesday, the company’s largest customer, a prominent Fortune 500 company, would overnight a payment to our client, usually in the millions of dollars. On one particular Wednesday, no check arrived. When the collection manager contacted the customer, he found out that the check was sent by regular mail. The client’s usual contact was on vacation that week, and her fill-in wasn’t aware that the check was to go overnight. ESB called the lender to let him know that the payment would be delayed for a couple of days and the reason why. As a result, my client found itself in a temporary over-advance situation where the company was in default of its loan agreement, and the bank could have returned outstanding checks. We explained to our account officer at the bank, who had more than 25 years of experience, that if the bank returned the checks it could cause severe interruption to the company and damage the sale process. We further suggested that the lender cover the checks and take on the temporary additional exposure.

The account officer, drawing on his experience and vision, alerted his superiors to the issues, and developed a strategy and plan to support and fund this temporary overadvance. This ultimately enabled the transaction to close, repaying the bank in total plus an enhanced fee and turning a $40 million workout and exposure toward a successful conclusion.

Without the account officer’s vision, experience, and expertise, as well as his willingness to take a calculated risk, a far less satisfactory result could have occurred. When it comes to working out a complex situation, who is on the point is usually one of the most critical components in determining the situation’s ultimate success or failure.

Both private equity and distressed investing funds have money to invest. No question, the parameters are now more stringent and the level of due diligence deeper, broader, and more pronounced.

Focusing, synthesizing, and identifying the opportunities for clients to optimize time, effort, and resources—locating that needle in a haystack—is one of ESBA’s strengths. We are now working with an investment banker to identify debt and equity participants to fund a realignment of the capital structure, including:

- An additional equity infusion.
- Converting a component of the revolver to a term loan.
- Restructuring the vendor and trade component.

This is to immediately stabilize the company through turbulent times.

**CONSIDER THE TRADE**

In today’s world, the rule rather than the exception is for a company to have vendors by choice or happenstance who have extended credit beyond normal terms. When clients find themselves on credit hold, the discussion usually centers on how the company can work with its trade group to gain additional support during the economy’s downturn. The “Catch 22” dilemma that suppliers find themselves in is that if they carry out on the usual threat to cut off supplying goods and services, the company may have to cease operating because it can’t get product in to sell; the vendor who is usually unsecured may not get paid back. The company should develop a course of action to show its constituencies why they should continue to support the company. Some key components of the plan should include:

- How is the company going to reduce expenses and generate additional revenues—for example, if it’s a retailer, will it be closing stores? If the company has excess inventory, is it willing to reduce the price to generate cash, absorbing an income statement loss?
- Communication—How are you going to communicate with your constituencies? Will it be done by letter, phone, or e-mail? Who is going to establish the communications and make the “ask”? These are not the easiest conversations to have.
- Capital Structure Changes—If you are going to ask for changes, extended terms, discounts, etc.,
it is critical to explain how the parties who are being restructured will benefit. In other words, why should they consider the plan? In most cases, should they not agree, the resulting realization will be substantially less. How you communicate it, “frame the pitch,” and translate the message is as important as, or maybe more important than, the message itself.

Early in my career, an equity sponsor and a lender gave me good advice: make sure you have a complete timeline and demonstrate that you have an excellent chance to meet it. That is:

- How long will you need the additional money/capital?
- How much do you need?
- What return can we expect?
- When can we expect to be paid back or have it returned?

In the recent past, it was human nature to first look for the quick fix, which is somebody to provide additional funding immediately. Today, it is a much tougher row to hoe. Before providing the financial wherewithal, the parties are demanding a plan that will outline details on:

- What value am I receiving for the additional monies invested?
- How is management going to fix the business—that is, right-size the cost structure?
- The potential for immediate increased revenue.
- Are the owners willing to share in the pain? Have they reduced their salaries, cut back on their lifestyle? What is their skin in the game? It is a critical question that must be addressed, especially if the owners have the financial means. The tone of the conversation is dramatically different if the owner can’t step up from a situation where they can, but won’t. It is important to be prepared on all accounts.

WHAT ELSE CAN WE ANTICIPATE?

The shift from being a “demanders” market in the past five or six years, where companies looking for capital have had the leverage, to today’s suppliers’/providers’ market, is dramatic (see Exhibits 1 and 2). This enables the suppliers to obtain better pricing, additional fees, and better structure, and to require the company to request additional due diligence components to ensure that their investment is sound. No question that it is providing substantial short-term pain, but it is likely to help both the company and the economy in the long term. It is just hard to accept that, as we’re going through the toughest stretch that the United States and all of us personally have gone through in the last 80 years.

Companies will most likely have to have more patience then they ever did before to manage the process. After years of equity and distressed investing firms hearing, “If you don’t complete the deal shortly, we have others that are willing to step in,” now it’s “We need just a few extra pieces of information or analysis.”

Change always presents obstacles and opportunities. As long as your foundation is sound, as we move to the new world order, opportunities will present themselves, although no question they are farther and fewer in between and will take time.

Look out of the box and to the path less taken. Ultimately it could provide the biggest opportunity and reward.

To order reprints of this article, please contact Dewey Palmieri at dpalmieri@iijournals.com or 212-224-3675.
The Changing Shape of Distressed Financing: Trends Driving the Evolution of a Market

DAVID L. JOHNSON

The distressed financing market is in the midst of radical, long-term changes. While there has been considerable change in the financing of distressed firms since the 1980s (a broadening of the DIP market, the institutionalization of distressed investing, loan-to-own strategies, etc.), in the coming years financial sponsors, turnaround professionals, and all others who interact with firms in financial distress will be faced with a vastly different financing landscape. The sources of these changes are apparent to any market observer. However, as the recent increase in corporate distress continues and many in our profession find themselves devoting their limited time to the immediate tactical concerns of today’s clients, it is worthwhile to pause in order to consider the financing environment that will exist for distressed firms in the coming decade.

A confluence of trends will drive the evolution of the distressed financing market:

- The continued adoption of the originate-to-distribute (OTD) model among traditional lenders.
- The continued growth and utilization of the secondary loan market to allow traditional lenders to exit troubled credits rather than pursue a workout.
- The continued growth and standardization in the credit default swap (CDS) market to enhance lenders’ ability to tailor their credit exposure.

Individually, no one trend would be enough to “shake the market,” but it is my view that their combined impact will soon reach a critical mass, after which distressed financing will be considerably altered.

A NEW APPROACH TO LENDING

Banks and other commercial lenders traditionally have played a substantial role in distressed financing, and this will continue. However, the pronounced shift to an OTD business model is a noteworthy development that has intriguing implications. As the role of traditional lenders continues to change, trends already in evidence will continue—structuring of debt facilities in ways that will be attractive to secondary market players, increased use of credit facilities in ways that will be attractive to secondary market players, increased use of credit risk transfer techniques, and a weakening of the monitoring role. The transition to a more capital markets-oriented lending universe has been slowed by the current economic environment, but the long-term trend is apparent, and it will persist.

The OTD model challenges the traditional economics of banking. In this model,
profit is no longer generated primarily through the difference between the rate at which a bank is able to borrow and the rate at which it lends. Rather, as a report by the Bank for International Statements puts it:

Banks now profit from leveraged loans not so much by receiving the interest rate spread, but by earning: fees received for arranging the loan; fees and trading profits associated with market-making in the secondary market; fees for arranging amendments to the loan agreement or covenant waivers; and fees and underwriting revenues associated with assisting CLO managers to set up and fund their vehicles.¹

Increasingly it appears that if banks are not able to apply the OTD model to an area of lending, they will gladly pull back from that area, as evidenced by the decline of U.S. banks’ share of the primary market for leveraged loans, from approximately 60% in 1999 to 20% in 2007 (see Exhibit 1).²

As the adoption of the OTD model by traditional lenders continues, the structure of debt facilities will be increasingly affected. In an insightful 2006 working paper, the BIS noted:

Covenant packages frequently appear to be designed to ease loan sales, given that over 60% of loan sales occur within a month of origination. More than half of sold loans are eventually resold, another indication that the intent is to create a loan instrument that will be liquid in the secondary market.³

And

Banks often sell loans that are designed specifically for an intermediation profit rather than for a long-run investment profit, using more restrictive covenant packages that mitigate selling costs. The riskier the loans, the likelier they are to be sold, controlling for other effects, perhaps because they tie down more bank capital.⁴

This trend must give private equity professionals and turnaround practitioners pause, as it implies an emerging order in which traditional bank workouts will be a thing of the past, and lenders with exposure to distressed credits are those who purposely sought out that exposure with a full appreciation of the risks (and potential rewards) inherent in their position.

The movement to an OTD model among traditional lenders provides strong incentives for them to more aggressively manage their credit risk. As the profit drivers of these firms shift from the interest rate spreads they enjoy to their ability to originate and service loans,
appetite for credit risk should logically decline. The two primary means of mitigating risk are selling a loan and buying CDS protection. Assuming loan maturity is equivalent to that of the default swap, the two options are economically equivalent (excluding counterparty risk), though loan sales are more beneficial when taking into account regulatory and disclosure requirements.5 The benefits of active credit risk transfer are considerable, and the emerging evidence indicates that those lenders who fail to adopt these techniques will quickly find themselves at a disadvantage.6,7

Traditional lenders have historically played an important role in screening and monitoring their debtors. In the past this role has been in the best interests of lenders, given their exposure. However, with the OTD business model, the incentives to maintain robust screening and monitoring capabilities are likely to decline.8,9 Recent academic findings on this topic are not encouraging:

Banks provide unique services in the form of credit evaluation and the monitoring of borrowers. For a bank to have the incentive to provide these services, it seems necessary that it hold a significant fraction of each loan that it originates. Although prior research addresses a bank’s motivation to monitor a loan after a portion of the loan has been sold, the efficiency of the post-sale bank monitoring remains an open theoretical and empirical question.10

The reduced incentives for traditional lenders to monitor their debtors (see Exhibit 2) may lead to an increased need for financial sponsors and other parties to more closely monitor borrowers in order to protect their investments.

The movement toward an OTD business model has significantly altered the economic incentives of banks in a short period of time, and a shift in this direction will continue, especially in areas related to distressed finance. Changes in the structuring of debt facilities are anticipated, as traditional lenders seek to originate loans that can more easily be sold on the secondary market. More aggressive use of credit risk transfer techniques seems inevitable, with not only increased sales on the secondary market but also increased use of credit default swaps to achieve an economically equivalent option. As the profit function of traditional lenders evolves, their rigor in pursuing the monitoring role which they have historically performed will decline. The implication seems to be that financial sponsors and/or other market participants will likely need to bolster their monitoring capabilities.

**THE SECONDARY MARKET: PAST AND FUTURE**

The secondary loan market has seen considerable change in the past two decades. It has experienced tremendous growth, particularly among leveraged loans. Years of benign credit conditions combined with the rise of the OTD business model have made use of the secondary market preferable to pursuing a workout for many traditional lenders. Finally, the emergence of large alternative investment firms with the capability to reallocate existing capital or raise new capital in pursuit of distressed opportunities has permanently altered the market. The result of these changes is that the secondary loan market is now sufficiently robust for traditional lenders to utilize it in their credit risk transfer strategies, exacerbating the changes that we foresee.

U.S. secondary loan market volume has seen remarkable growth in the past two decades. Volume has increased from $8 billion in 1991 to more than $318 billion in 2008. It is especially noteworthy that this growing market seems to focus on credits that are either currently, or have a higher likelihood of at some point becoming, distressed. Data from Reuters Loan Pricing Corporation indicates that from 1991 to 2008 there was

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**EXHIBIT 2**

Estimates of Syndicated Loan Retention by Lead Arranger

![Image of Exhibit 2](image-url)

Source: Sufi [2007].
no single year in which less than 9% of secondary loan purchases were distressed, and in the 2001–2003 period distressed loan sales averaged 39% of total secondary loan sales (see Exhibit 3).

It is also noteworthy that leveraged loans account for a majority of the secondary market. As a recent research paper by the FDIC noted:

In contrast with typical loan syndications, the secondary loan sales market is dominated by leveraged, risky loans and the majority of loans are purchased by nonbank, institutional investors. As such, the secondary loan sales market is economically important, allowing banks to diversify their loan portfolios, comply with risk-adequacy regulations, and continue to fund profitable projects even when capital constrained or when facing higher internal lending costs.\(^{11}\)

There has been considerable research regarding the effect of the secondary loan market on the customary monitoring role of traditional lenders. Historically these lenders have provided valuable monitoring that has benefited other market players due to their sensitivity to a debtor firm’s downside and relative indifference to its upside. A recent paper that explored the topic concluded the following regarding use of the secondary market by traditional lenders:

It can reduce the incentives of banks to monitor a borrower since a bank can use the secondary market to reduce its lending exposure to a borrower. If so, such a “loan sale” could significantly reduce or even eliminate a bank’s incentives to monitor the borrower.\(^{12}\)

While the matter remains an open question, it is important to recognize the emerging academic view that as traditional lenders utilize the secondary market, their incentives to monitor decrease.

The relatively benign credit market of 2003–2007 led many traditional lenders to make staffing adjustments with considerable long-term implications. With a growing secondary market and a half decade of low default rates, many traditional lenders substantially reduced their workout departments, and now face challenges in hiring and/or training sufficient numbers to address a deluge of troubled credits. Arguably the loss of talent in workout departments, coupled with the increasing liquidity of the secondary markets, will further push traditional lenders toward a preference for loan sales over workouts.

The current decade has seen the evolution of a select number of alternative investment firms into sprawling entities that pursue a wide range of strategies across numerous funds. These firms have a demonstrated ability to shift existing funds to or raise new funds for attractive investment opportunities. The presence of these firms and their ability to rapidly reallocate capital is likely to address, in part, the issue of demand for the abundant supply of distressed loans that seasoned professionals anticipate will be a facet of the market for the next few years.

Numerous factors have combined to make the secondary market an increasingly important aspect of the broader distressed financing market. There is the undeniable reality of the secondary market’s stunning growth, as well as its tendency to focus on distressed and leveraged loans. With workout departments pared down after years of low default rates, we expect to see banks more willing to exit distressed credits as opposed to going through the workout process. As alternative investment firms aggressively seek distressed investing opportunities in the current environment, demand will surge to meet supply and pricing will be less punitive than might have been the case in past cycles. We view the secondary loan market as having reached critical mass in terms of its importance to the broader distressed financing market, and believe that the

**E X H I B I T  3**

Size and Composition of the U.S. Secondary Loan Market

![Graph showing size and composition of the U.S. Secondary Loan Market](source: Reuters Loan Pricing Corporation.)
secondary loan market will become a driver of change going forward.

THE CDS MARKET: AN UNDERUTILIZED HEDGING TOOL

The credit default swap (CDS) market has matured to the point that we believe it is now a reliable-enough tool to be utilized in ways likely to have a profound effect on distressed finance. In the space of less than a decade, the CDS market has experienced explosive growth as well as an increasing focus on standardization. Recently, there has been evidence of traditional lenders making use of CDS products in order to tailor their credit exposure, and these kinds of transactions will become increasingly common. What was once a chaotic and unfamiliar market is now a large, reasonably standardized one capable of providing traditional lenders with another means of transferring risk, and hence furthering the evolution of the distressed financing market.

Growth in the CDS market has been breathtaking, but in recent years, steps have been taken to increase the utility of this important market. The rate of growth this market has seen is staggering: the notional value of the CDS market has increased from $918 billion in 2001 to $62 trillion in 2007 (see Exhibit 4). Long marked by rampant customization and the lack of a central clearinghouse, the CDS market is beginning to acquire the markings of maturity. Many products, especially index-based CDS contracts, have become standardized. Electronic trades have risen above 90%, versus 50% in 2005. These trends, combined with the recent pledge by 17 large dealers to create a clearinghouse by year-end, have done much to ease concerns regarding the stability of the CDS market.

As the CDS market matures and risk management officers gain a better understanding of counter-party risk (the risk that the provider of default insurance will itself default), we expect to see banks and commercial lenders make broader use of CDS contracts in order to protect themselves from deterioration in the debtor’s business (up to and including a default) (see Exhibits 5 and 6). The Federal Reserve has noted that a number of large European banks have recently executed transactions to hedge exposure to a range of credit risk categories. This trend will continue, and far from being without precedent, it would be similar in many ways to what we witnessed with the mortgage market earlier in this decade.

The use of CDS products by traditional distressed lenders is an economically logical extension of the OTD model that has become prevalent in the market. As the CDS market has matured, liquidity has increased. Lenders, recognizing the benefits of a market-based model, have displayed a willingness to rely on the liquidity of the credit markets, and despite the current market turmoil, this will continue. A recent study has indicated that the CDS market also serves as a strong predictor of ratings activities, with Fitch Solutions estimating that the CDS market has

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**EXHIBIT 4**

Notional CDS Amounts Outstanding at Year-End

![Notional CDS Amounts Outstanding at Year-End](source: ISDA Market Survey [1987–2007].)
**EXHIBIT 5**
CDS Hedging Transactions

<table>
<thead>
<tr>
<th>Date</th>
<th>Bank</th>
<th>Credit exposure before hedging (billions)</th>
<th>Amount of hedging reported (billions)</th>
<th>Exposure hedged (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year end 2006</td>
<td>Bank of America</td>
<td>USD 618</td>
<td>USD 8</td>
<td>1</td>
</tr>
<tr>
<td>Year end 2006</td>
<td>Citigroup</td>
<td>USD 633</td>
<td>USD 93</td>
<td>15</td>
</tr>
<tr>
<td>Year end 2006</td>
<td>JP Morgan</td>
<td>USD 631</td>
<td>USD 51</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td>Chase</td>
<td>EUR 60</td>
<td>EUR 15</td>
<td>25</td>
</tr>
<tr>
<td>2006 Q1</td>
<td>Societe Generale</td>
<td>EUR 60</td>
<td>EUR 15</td>
<td>25</td>
</tr>
</tbody>
</table>


**EXHIBIT 6**
Aggregate Loan and CDS Positions within Large Banks (Banks with at least $1 Billion in Assets in 2003)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total loans</th>
<th>CDSs bought</th>
<th>CDSs sold</th>
<th>CDSs gross</th>
<th>CDSs net</th>
<th>CDSs bought % of loans</th>
<th>CDSs sold % of loans</th>
<th>CDSs net % of loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>2,125</td>
<td>217</td>
<td>220</td>
<td>437</td>
<td>-2</td>
<td>10.2%</td>
<td>10.4%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>2002</td>
<td>2,238</td>
<td>342</td>
<td>288</td>
<td>630</td>
<td>54</td>
<td>15.3%</td>
<td>12.9%</td>
<td>2.4%</td>
</tr>
<tr>
<td>2003</td>
<td>2,379</td>
<td>520</td>
<td>469</td>
<td>988</td>
<td>51</td>
<td>21.9%</td>
<td>19.7%</td>
<td>2.1%</td>
</tr>
<tr>
<td>2004</td>
<td>2,671</td>
<td>1,179</td>
<td>1,092</td>
<td>2,270</td>
<td>87</td>
<td>44.1%</td>
<td>40.9%</td>
<td>3.3%</td>
</tr>
<tr>
<td>2005</td>
<td>2,891</td>
<td>3,002</td>
<td>2,518</td>
<td>5,520</td>
<td>484</td>
<td>103.8%</td>
<td>87.1%</td>
<td>16.7%</td>
</tr>
<tr>
<td>2006</td>
<td>3,298</td>
<td>4,165</td>
<td>4,084</td>
<td>8,259</td>
<td>71</td>
<td>126.3%</td>
<td>124.1%</td>
<td>2.2%</td>
</tr>
</tbody>
</table>

Source: Federal Reserve Bank of Chicago.

**EXHIBIT 7**
Estimated Breakdown of CDS Buyers of Protection


**EXHIBIT 8**
Estimated Breakdown of CDS Sellers of Protection

anticipated some ratings activities more than three months in advance. Heightened lender utilization of the CDS market (see Exhibits 7 and 8) is supported by the benefits of increasing liquidity and the observed predictive power of the market. Given this compelling logic, lenders will continue to increase reliance on the CDS market in order to realize these benefits.

CONCLUSION

The distressed financing market is undergoing a period of fundamental change. The level and type of involvement in this sector by traditional lenders is in flux as adoption of the OTD model drives a rethinking of the appropriate level of credit risk to retain. Alternative investment firms lacking the origination capabilities of traditional lenders but eager to participate through the secondary markets are primed to play an increasingly active role in this market. The ability to tailor credit exposure without a loan sale through use of the CDS market offers another avenue for traditional lenders seeking to more actively manage their risk profile. The outline of the emerging order is becoming clear, and it rests with all professionals involved in the distressed financing market to make the necessary adjustments.

Historically, banks and other commercial lenders have played a substantial role in distressed financing, and this will continue. The emergence of the OTD model has altered the profitability equation for traditional lenders, with the result that many are likely to engage in increasingly proactive credit risk transfer activities in order to maximize profitability under the new business model. Despite their historically dominant role in distressed finance, recent market developments have drastically altered the incentives of traditional lenders, providing an opening for capital providers with more aggressive risk tolerances.

Over time, the secondary loan market has achieved critical mass, allowing it to become a driver of further change. The size of the market and its focus on distressed and leveraged credits ensures that it will become an increasingly important aspect of the broader distressed financing market. As traditional lenders seek to originate loans that can be easily sold, the influence of the secondary market will spread throughout the broader distressed financing market.

The maturation of the CDS market offers tantalizing opportunities for traditional providers of capital to tailor their level of exposure to firms of all sizes. With the development of CDS indices it is now possible to construct hedges for exposure to middle-market firms, thereby considerably broadening the usefulness of the market for traditional lenders seeking to mitigate credit risk. In the coming years, traditional lenders will make increasing use of the CDS market in order to tailor their credit risk.

Considering the impact of these trends, we foresee changes great and small for the distressed financing market. Adoption of the OTD model by traditional lenders will drive them to seek to minimize credit risk and will potentially inhibit their customary monitoring role. The secondary market, now large enough to be relied upon as an aspect of a comprehensive credit risk transfer strategy, will exert increasing influence on loan origination as lenders seek to originate loans that can more easily be sold. Through the CDS market, traditional lenders will be able to carefully tailor their credit risk, and these lenders will seize this opportunity. In the near future, we anticipate a distressed financing environment in which workouts are rare; monitoring by traditional lenders is minimal; the secondary market is a component that cannot be ignored; and even current lenders may be indifferent to a default. Truly, it will be a brave new world for which all forward-thinking professionals in this industry should prepare.

ENDNOTES

2 Ibid.
4 Ibid.
5 Ibid.
6 Ibid.
The Effect of Lenders’ Credit Risk Transfer Activities on Borrowing Firms’ Equity Returns.” Bank of Finland Discussion Paper, July 2006.


Ibid.

To order reprints of this article, please contact Dewey Palmieri at dpalmieri@ijournals.com or 212-224-3675.
In recent months, greedy executives have given pay-based bonuses a bad rap. That's unfortunate, because incentive compensation is a vital, essential, and frequently overlooked tool when it comes to turning around a poorly performing company. This is especially true when the focus is on employee incentive compensation. If substantial improvement is to be made to a struggling company's EBITDA, a seismic change in the entire corporate culture must take place, starting at the grassroots (or factory, or office) levels where employees work.

A turnaround plan that incorporates team-based performance and results-based incentive bonuses for managers and employees can create amazing results in a financially challenged company. It must, however, be designed so that managers and employees are given ownership over their portion of the P&L to support a specific customer segment.

**WHAT'S WRONG WITH THIS COMPANY?**

Typically, employees within a company in serious decline feel little or no ability to alter outcomes or improve the overall performance of the enterprise. And that’s a monumental problem, especially since all of a company’s work is done by its employees. Unless employee attitudes are improved, there’s little chance the company will turn around. The dilemma is that most business owners, equity sponsors, and shareholders are blind to the true nature of this daunting predicament. It’s the elephant in the boardroom that owners and investors neither see nor understand. Employees don’t bring it up because, well, why bother? If they’ve raised the issue in the past, they were very likely ignored, or worse, punished in some way for their candor.

This problem, however real, doesn’t show up as a line-item on the P&L statement, nor does it emerge as a discrete category in even the most thorough EBITDA calculation. That’s because it’s a product of something much more ephemeral and harder to quantify: the corporate culture.

Infusion of new capital and energy from an investment group rarely improves an ailing corporate culture. If anything, the purchase of a distressed company by new owners usually has the reverse effect, worsening what was already dangerously low employee morale. Employees today are very well-informed and highly sensitive to even the slightest changes in the company. So, when truly dramatic rearrangements such as a change in ownership occur, most employees are quite aware that within a few years, the new investors will either flip the company or dismantle it and sell off the pieces. The outlook, from the average employee’s point of view, is dismal.
Unless systemic, positive, and enduring changes are made to the corporate culture—and quickly—the company’s decline will continue.

ANALYSIS OF THE PROBLEM

How can private-equity investors determine whether (and where) such a problem exists? The first step requires a willingness to take a more active role in the initial due diligence process. Outside professional help will often be needed, as well.

The first order of business for a newly engaged CTP (Certified Turnaround Professional) is to get out and meet with and talk to the employees, from hourly laborers to administrative assistants and junior managers. When asked, most employees will gladly discuss what they see as wrong with the company—granted, of course, that they have no fears of reprimand or retaliation. Once an employee’s trust and confidence are earned, it becomes quickly apparent that their assessments of what’s amiss are usually right on target. The top two items on the list are often:

- Employees are not listened to and sense that they have little or no say in the day-to-day, essential decision-making that affects their work-life, even though employees are the “brain-trusts” when business challenges exist.
- The feeling of having no power to control the company’s productivity and its profitability, and for all intents and purposes their own fate, is profoundly demoralizing. Knowing what employees know and seeing those issues ignored by management, the Board, or new equity sponsors is disconcerting. Moreover, demoralized companies do not, as a rule, demonstrate robust EBITDA.

Most employees have a wealth of valuable and very credible ideas about how to improve things. Even more to the point: they earnestly want to be part of the solution and to have a say in important decisions. Shockingly few investors, owners, and executives understand or utilize the fundamental truth that employees have their company’s best interest at heart and want to see it succeed. That’s where the rub is, because the energy, expertise, and corporate wisdom of a corporation’s employees is precisely what must be engaged and harnessed to move an under-performing company in a new, more profitable direction.

Most equity sponsors introduce company-wide incentive compensation programs based on improvement to the company’s EBITDA. While senior executive incentive compensation programs make this an excellent performance metric, most employees believe they have very little direct control over EBITDA. Far too many of these programs end up de-motivating the rank-and-file employees.

A team-based employee incentive compensation program, with individual performances tied to the company’s direct contribution margin (DCM), featuring quarterly cash bonuses, is an outstanding method of winning crucial buy-in and fostering a sense of committed ownership among employees. Critical in the design of DCM team-based incentive compensation plans is establishing business-segment, product-line, or geographic customer-centric DCMs. And because DCM is a component of the company’s EBITDA, it is a good proxy to measure and reward performance while creating increased enterprise value for the equity sponsors (see exhibit).

From a strict cash flow point of view, such programs, when successful, are like a goose that lays golden eggs—they’re self-funding and self-reinforcing; success builds upon success, which in turn attracts higher levels of employee enthusiasm and buy-in. Moreover, as word gets out on the street, it will begin to attract new, similarly enthusiastic and high-caliber employees looking for a vibrant, meaningful, and rewarding place to work. To be effective, such a program must work in concert with other substantive changes in the corporate culture.

Many companies, having heard about the benefits of employee recognition, incentive, and reward programs, often give them a try. Many do it for all the right reasons. Without question, employees should share in their company’s increased value (after all, that value is due largely to their efforts). Far too many companies that implement incentive programs, however, hold out unreasonable hope in their transformative power. The market is glutted with professional employee benefit service firms and systems that may, admittedly, get the bonus numbers calculated correctly, but remain tone-deaf to something much more important: the human element. These programs essentially boil down to one-way, top-to-bottom financial gestures made by
the company's leaders. They fail to address the true nature of the company's productivity and profitability problems; improvement, if any, will be incremental and probably not long-lasting. As for inspiring substantive change—the kind needed to actually pull a sinking company back from the precipice and set it on a more profitable trajectory—they're rarely sufficient.

To build a company's value in a meaningful way, a team-based incentive program cannot work in a vacuum. But for the true power of such a program to be unleashed, employees must be granted greater ownership of a company's DCM. There must be a direct link, a feedback loop, between their efforts and the quarterly bonuses they receive from their incentive program. The missing link in this particular loop is influence (there's that word again). It is important for employees to have a sense that they have skin in the game, along with a substantive control over and investment in the company's fundamental, on-the-ground decision-making processes.

### THE CHANGE PROCESS

Follow this four-step process to see quantifiable and qualitative changes.

#### Step One: Understand the Capability of the Company's Financial Reporting System

This is an important part of the turnaround professional's initial assessment of the business. Ideally, accounting systems that track monthly performance of a customer type, product line, geographic area, or business segment are best suited to the task of implementing direct contribution margin (DCM) incentive programs. Caution: allocation of costs in deriving DCM will create de-motivators for employees because they will be viewed as “non-controllable” costs.

The objective should be to measure customer, product line, geographic area, or business segment DCM for all related revenues and direct costs and align employee...
teams to support the distinct customer, product line, geographic area, or business segment DCM. In addition, multiple teams should be established and charged with the goal of improving customers’ expectations and satisfaction while simultaneously growing “their” DCM.

Step Two: Assume a Customer-Centric Focus

If this sounds like a huge undertaking, it’s because it is. The first step in the process is to change the corporate mindset, top to bottom. That should begin with the process of educating everyone in the company about something so obvious and fundamental that most people—employees and executives alike—rarely ever think about it. This central problem is neatly summed up in the responses one hears to the following question: “Who do you work for?” Ask employees in a distressed company where their paycheck comes from, and they’re very likely to answer, with genuine sincerity: “the boss,” by which, of course, they may mean their CEO, private-equity shareholders, or maybe even the manager to whom they report.

All of those answers are understandable, yet 100% incorrect. In reality, everybody, from the CEO to the janitor on the shop floor, works for the company’s customers. Until everyone in the enterprise internalizes this fundamental axiom of business life and immediately begins changing the company’s focus to a customer-centric orientation, there’s little hope for the future. Realigning the organization into cross-functional teams to support a given set of customers, a product line, a geographic area, or a business segment helps realign the focus to the company’s customers.

Step Three: Perform a Quiet Revolution

What does this change in mindset really involve and require? It’s hard to underestimate the depth and breadth of the task. The company needs to go through nothing less than a quiet revolution. Power, in the form of substantive decision-making authority, must be re-distributed. Executives will lose some—at least as they’ve understood it over the years—and employees must be given more. For those corporate leaders and owners accustomed to top–dog positions in what are essentially semi-autocratic organizations, this is going to be a difficult and painful passage. And maybe not all that quiet—one can almost hear the howls of protest in the background now. For employees and staff, however, the process is liberating and exhilarating.

So what does this mean? Are company leaders expected to sit on the sidelines and watch the action on the field go by without them? Hardly. Their roles must expand and change from that of top-down decision-makers to something much more crucial, and in the long run, infinitely more rewarding, on a personal and a business level: They must evolve into true mentors and coaches.

For now, the company—especially if it’s distressed—must realign and reorganize around its customers if it is to survive and grow its EBITDA, and hence enterprise value. Most of this activity needs to include employees who are directly involved in product design, manufacturing, sales, marketing, and any form of customer contact or service. The central organizing concept behind this transformation is an assembly of cross-functional teams that meet frequently. They share a customer-centric orientation and rely on accounting systems that provide continuous feedback on their results within the framework of the team’s direct contribution margin (DCM).

Employees must go beyond simple awareness of their DCM—they must truly own it. The days of compartmentalized departments, each with separate and protected fiefdoms, are over. The company’s entire focus must be transformed into a holistic, team-centered approach. If sales of a particular product are down, it’s no longer a “sales problem.” It’s everyone’s problem, concern, and challenge. If a customer shipment is placed on back-order, for example, the team will need to assess and implement the improvements needed to the supply chain. Saying this is easy, but making it happen is a bit more complicated. However, a strategic incentive compensation program plays a lynchpin role in the successful transformation of a heavily siloed corporation to one with a dynamic, interacting network of teams possessing a single focus: understanding customers’ needs and delivering the product or service they want, on time and profitably.

Step Four: Turn Executives into Mentors

The process of making significant changes in the culture of a corporation, especially the sort described here, usually encounters its greatest resistance at the top. A company’s leaders occasionally resist a turnaround professional’s recommendations, especially when they
involve relinquishing specific decision-making authority. Even for companies teetering on the verge of collapse, the idea that an executive team needs to change or adopt a new mindset can be a tough sell. Paradoxically, the nearness of catastrophe often hardens an executive team’s resistance to change. When the best efforts of a turn-around professional fail—and it does happen, although infrequently—the predominant cause is the unwillingness of executives to integrate meaningful, transforming change.

In short, what’s required of the management team of a troubled company is to evolve to the next level of performance, to acquire an attitude and philosophy demonstrated by the very best leaders in the world. This next leap forward asks executives to stop handing out directives and start leading by example. They must become mentors. Their new mission will be to create within the company an atmosphere in which change, learning, advancement, and independent thinking are encouraged and cultivated on every corporate level.

Mentoring is founded on the ancient master/apprentice archetype—the fundamental and intimate human relationship between two people: a teacher and learner. It’s no understatement to say that it plays a pivotal role in most significant human advancement. Sadly, it’s underutilized in the modern business world.

Becoming a mentor requires acquiring and continually improving one’s ability to:

- Inspire people.
- Encourage fellow executives, managers, and employees to believe in themselves and support one another, especially in the early stages of transformation.
- Be calm, logical, and sensitive when dealing with the irrational or erratic behavior of other people.
- Embody the company’s vision, values, and strategy in every aspect of one’s daily walk, professionally and personally.

NEW SKILL-SETS AND ROLES FOR LEADERS

The skills involved in being an effective mentor or coach have much more to do with one’s EQ (emotional intelligence) than IQ. The role demands a high level of people skills on the part of the mentor and a corporate culture that reinforces and encourages trust and confidence from the top down. Employees and managers need to be confident in their ability to make mistakes without fear of retaliation; to know that indeed, mistakes are how one learns and steadily improves. When the mentor/mentoree model is integrated and accepted into a corporate culture, it can literally catapult individuals into their optimal levels of achievement in both the professional and personal realms of their lives. Of course, that’s the secret of how entire organizations are transformed. The process unfolds one person at a time.

A thriving mentoring culture requires a core group that understands the principles of EQ and becomes its active protagonists. Change of this magnitude can only start at the very top. The process nearly always faces significant resistance from people who aren’t comfortable with non-linear, experimental, and ambiguous experiences, which to some extent, includes everybody.

Here are some of the characteristics of a dynamic corporate culture centered on the concept of mentoring and the qualities associated with it:

- A vibrant and unambiguous corporate mission, a “reason for being and working here” that instills a deeper meaning in each employee’s daily efforts.
- A compelling need for change in the company, accompanied by a well-articulated road map for getting there.
- Generous respect for and encouragement of human diversity as it relates to each individual’s ideas, way of thinking, work style, and background.
- An uncomplicated and transparent incentive system that rewards the achievement of individuals and their respective teams on a quarterly basis based on growth in team-based DCM.

CASE STUDY: CASE LOGIC, INC.

Founded in 1984 in Boulder, Colo., Case Logic helped create and expand the field of audio products storage. Today, the company offers a full line of portable and home storage accessories for CDs, DVDs, portable electronics, laptops, cameras, and automobiles. It has recently expanded into the travel and luggage market with backpacks, messenger bags, and luggage. Case Logic is now owned and operated by Thule, a leading company in sports utility transportation.
Mounting Problems

In November 2003, when Amir Hoda came on board as the new vice president of global operations, the company was facing significant difficulties. It employed 275 people, with approximately half based in the main offices in Longmont, Colo., with the balance spread out among sales and distribution offices in Canada, Belgium, Germany, Spain, the Netherlands, and a sourcing office in Hong Kong. All manufacturing took place in China, where an additional 2,500 workers were engaged.

In 2003, sales were approximately $150 million and reported EBITDA approximated $4 million, with senior and sub-debt totaling $120 million. The company could not meet debt service and had no free cash flow for badly needed product development.

Case Logic was a mature company that had enjoyed quite a few years of success in the soft-side, cut-and-sew business, but was stagnating, evidenced by declining margins, sales, and new product development. The company’s specialty—audio organizational products—has traditionally been a low barrier-to-entry field, and competitors were gaining fast. Employee turnover at Case Logic was not a problem, due in large measure to a rich benefit program that included excellent self-funded insurance, 10% matching 401(k) plans, and very generous PTO allowances. Employee incentive compensation was based on EBITDA, less a net asset charge.

Clearly, many of the basics needed to attract, motivate, and retain top-flight employees were in place. What the organization suffered from, however, was complacency, especially in the sales and product development departments.

“Years of success had instilled a sense in the company that it was exclusively due to their internal efforts as a company,” says Hoda. “This belief ignored the fact that a good share of our past success was actually attributable to a robust, rapidly growing CD/DVD products market which carried Case Logic along with it.”

So, when the overall world market began contracting due, in part, to consumers shifting from CDs to MP3 players, Case Logic’s problems threatened the company’s long-term and short-term survival prospects.

Despite this dire picture, an overall lack of urgency continued to pervade the entire company’s day-to-day productivity, particularly process improvement as it related to sales, R&D, design, and customer service.

“The feeling among many employees was ‘Hey, we’ve been successful before, and we can do it again in the same way,’” says Hoda. “There was substantial resistance to the idea that we’d have to reorganize the entire way we operated.”

It was obvious to Hoda and other executives that the company needed to significantly grow its top-line revenue, increase its product development, and diversify its product offerings. It was at this point that Case Logic began working intensively with The Scotland Group, Inc. “We both started working at Case Logic on exactly the same day,” recalls Hoda.

Structural, Strategic, and Tactical Changes

After a period of analysis and discussion with employees, key personnel, and executives, the first order of business for the turnaround firm was to reorganize the company around product management silos with cross-functional teams. Each product silo’s team was led by a product manager who supervised the sales staff, supply chain people, R&D, factory workers, and related employees. The plan was to create a network of broad-based teams, each of which supported a specific product-line segment. Prominent segments included camera cases, DVD/CD wallets, and OEM-market products. Fortunately, the company’s existing accounting and financial reporting systems were solid and able to accurately track product line P&Ls, which in turn made it possible to segment the P&L. Developing ongoing P&Ls for each team was a top priority. Everything was then tied to DCM as the means to motivate people. Attractive bonus opportunities were made available to each team in two components—one for meeting planned DCM, and a second for exceeding planned DCM.

One of the biggest challenges for the executive team was to make sure that the goals of each segment of the company—sales, marketing, and operations—tied in to one another and supported the overall direction they wanted the company to move in. It’s dangerously easy at this point to lose sight of how conflicting departmental goals can obstruct the company’s turnaround.

“At the very front end,” says Hoda, “when you’re setting the strategic direction, as well as the higher-level tactical plan, everyone must be made cognizant of conflicting goals. It’s absolutely critical. For example, you can’t just say to the sales team, ‘Grow sales volume 25% in X,’ a high service-requirement channel, then turn to...
operations and say ‘Oh, by the way, you have to reduce inventory by 50%.’ If you’re going to target a high-service client, you must be able to support that effort. Again, all these goals must tie together, and it’s the leadership team that’s ultimately responsible for making sure they’re aligned and that the metrics chosen to measure success versus failure support those goals.”

Goals must also be realistic. As obvious as this sounds, it’s an essential and often overlooked point, says Hoda. “You have to be real in terms of what can and can’t be done. If productivity at the warehouse level is 20 cents per carton (the cost to handle it), you can’t just say ‘I want it to be 2 cents.’ You have to set a goal that’s reachable, such as 17 cents.” That realism must be applied across the board, throughout changes made in every department.

**Behavioral Changes also Key to Success**

“For me,” says Amir Hoda, “the surprising—and really interesting—part of our turnaround efforts revolves around human behavior. You come up with a plan. OK, now how do you get people to make it happen? No two people think the same way or are motivated by the same things. Some people thrive on a challenge. Others don’t. Some people work best when there’s a sense of alarm or urgency, or even a climate of fear. Every company has its share of optimists and those who are pessimistic. How do you manage change given that? We found team- and DCM-based incentive compensation is a powerful way to accomplish it.”

How sales staff compensation was handled deserves special attention. Deanne Lederer is a former human resources manager at Case Logic who was very involved in the changes implemented by The Scotland Group, Inc., with help from Case’s Logic’s executive team.

“We looked at the market in terms of what salespeople at other companies similar to ours were making relative to their experience,” says Lederer. “We saw that our salespeople were paid about 20% more than the average market salary, and our bonus structure was a little lower; bonuses were capped at 30% of a salesperson’s pay. So we ended up reducing our sales staff’s base pay an average of 18 to 20%.”

Salespeople had to be retrained to sell items that they were neither comfortable nor familiar with. They were kept on a group bonus structure (tied into EBITDA and earnings), but it became a much smaller percentage of their overall DCM team-based variable pay. As an incentive target, they were allowed to earn a total of 80% of their pay in variable compensation as well as what was directly under their control, i.e., top-line revenue and DCM margin for sales, based on the product line they were selling, and how well they managed the outside reps.

“Here’s an example of how that played out,” says Lederer. “Audio business was relatively easy to get, so it was weighted less than the emerging markets that we wanted to expand into. Also key was requiring sales staff to manage our independent reps. For those who were truly motivated, it helped them make more money. It should be noted we also gave an incentive to those outside reps.”

To deal with the sales staff’s sizable anxiety (and outright fear of losing their jobs), the company allowed them to take a monthly draw on their bonus. Those draws were temporary and lasted about a year. Another pivotal change in the company incentive compensation structure was a decision to disburse bonuses on a quarterly, rather than an annual basis.

“Salespeople,” notes Lederer, “because of their unique personality makeup, generally perform better with frequent gratification, so we decided that quarterly bonuses were a good way to place the reward closer to their efforts. Another benefit was that we got a chance to see who really would perform. In that first year, one of our sales staff ended up making more than our executives. Now that’s motivated!”

On the flip side, some of the salespeople ended up leaving the company. In terms of a motivation engagement and an analytic tool, the new system worked remarkably well.

Case Logic also set aside $50,000 for quarterly discretionary bonuses for employees who did outstanding work and came up with key process improvements to support the turnaround initiatives.

“There were five main criteria,” explains Lederer, “and each quarter, managers would push up ideas and recommend people to a committee of vice presidents, HR managers, and the turnaround staff. We then rewarded those people with big checks at the company meeting. It was very exciting and worked exceptionally well in our small and close-knit culture. People were really happy for those who won awards, but even more to the point, it inspired others to work harder and more creatively.”
That was essential, because of the significant gap between Case Logic’s existing financial picture versus where it needed to be. “If we had just announced to everyone, ‘OK, here’s our EBITDA target—we need to grow 25% this year,’” says Lederer, “I don’t believe our employees would have made the changes in behavior necessary to achieve those goals.”

However, with the overall employee team DCM-based incentive compensation program combined with the quarterly cash award program, those goals were exceeded by a very wide margin.

How well? In 2004, seven months after engaging the professional turnaround managers, Case Logic’s EBITDA was on a sustained $21 million run rate, up from $4 million the prior year, largely because of:

- DCM-based incentives and shared quarter-end bonuses provided to employees to grow DCM and hence EBITDA.
- A rationalization of the company’s product offerings.
- Crystallization of the company’s sampling process, particularly for the Big Box retail channel.
- The executive team’s ability to demand—and get—a shortened “time to market” metric from time of initial design to the date products actually appeared on store shelves (i.e., reduced from 16 months to 16 weeks).
- Expansion of distribution channels into new markets.

Structural changes are essential to the overall process, but they are no more pivotal than the profound behavioral changes that needed to be made by everyone at Case Logic. Significant structural changes (including team DCM-based employee compensation incentive plans) will simply not succeed unless individual employees buy into them and the corporate culture—which is made up of individuals—supports the changes. This is the most challenging area of any turnaround professional’s job.

**LESSON LEARNED**

Turning around a company in distress requires a bold alchemy that obviously focuses on the numbers and the human side of the equation. Focusing on one without the other will not provide enough inertia for the company to clear the hurdles necessary to avert disaster. Owners, investors, and employees need to learn how true value is created in a company and who that value is created for (their customers and owners), and then all pull in the same direction, rather than at cross-purposes. It nearly always takes the skills and impartial, clear-eyed view of a trained turnaround professional to get the process started, but make no mistake: the real work is done by every individual associated with the enterprise. It is only fitting that the rewards must flow to them, as well. Well-designed team- and DCM-based incentive compensation models create sustained value and are vital for all operating turnarounds.

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Investors, Turnaround Professionals, and Fraud: “First Do No Harm”

JOSEPH D. KENYON

When an investor or a turnaround professional becomes involved with a new or troubled business, often in the back of their mind is the question, “Is there a high risk of fraud occurring at this company?” Seldom do they also think to ask, “Am I setting up the motivation and opportunity for fraud?” Both questions are important in an investor or turnaround situation where an awareness of the red flags of fraud and the conditions that encourage fraud can play an important role in the long-term prospects of an emerging or struggling company.

The types of fraud that may be occurring in any company include:

- Asset misappropriations (stealing cash, fraudulent disbursements, or misappropriating other types of assets such as inventory or confidential customer financial information).
- Corruption fraud (bribery or conflicts of interest).
- Financial reporting fraud (intentional misstatement of the financial statements).

Why are certain businesses at a high risk of fraud? There may not be enough employees or concern by management to provide proper segregation of duties and assure that the same person does not have control of a transaction from beginning to end. For example, when the same person signs checks, records them on the company’s books, and reconciles the bank account, this provides the employee with the opportunity to cover up misappropriated cash. The business’ accounting records and systems may not be properly maintained or kept up to date, and this also provides an opportunity to cover up fraud in the disarrayed records. Poor or unethical management may send a message to employees that fraudulent or improper accounting principles are considered an acceptable (or even desired) business practice. Employees unhappy with their and the company’s financial situation rationalize that they are owed the cash they stole because they are underpaid.

Small, family-owned and fast-growing businesses can be more vulnerable to fraud. These types of businesses are usually very cost-conscious and may not appreciate the necessity of an adequate system of internal controls. This can be particularly true in situations where a business has grown dramatically from a small unsophisticated operation to a much larger, more complex, and more diverse business in a short amount of time. When this occurs, it often takes time for the system of internal controls and infrastructure to catch up with the needs of the larger, more complicated business. These unusually fast-growing companies are often...
considered to be highly desirable by potential investors who, enamored by the growth, may not be vigilant to the potential of higher risks of fraud.

THE RED FLAGS OF FRAUD

An investor or turnaround professional involved with the subject business should be on the lookout for the “red flags” of fraud:

- Significant weaknesses in internal controls.
- Poor accounting systems.
- Management’s lack of concern over unethical behavior.
- Unhappy employees.
- Unusually complex financial transactions or transactions with no apparent business purpose.
- Unusual related-party transactions.
- Unexpected financial performance.
- An unusually complicated organizational structure and nonsensical financial relationships.
- Significant turnover of senior management (particularly those involved with accounting), legal counsel, outside accountants, or board members.

In situations where an owner is attempting to sell a business for its highest value, there are also greater risks of fraud as the owner may be motivated to invent higher cash flows that he hopes will be converted to a higher purchase price by a potential buyer. The risk of fraud is even higher for businesses operating in an industry suffering from an economic downturn. Businesses going through a changeover of management and/or ownership are also at greater risk of fraud as employees or management may find opportunities to take advantage of this situation during the time of change.

It is standard practice of an investor or turnaround professional to perform a financial analysis of the subject business to attempt to identify any problem areas or operating issues to be addressed, such as trends in historic gross margins and net profits, level of indebtedness, amounts and trends in cash flows, and the assessment of the entity’s future viability. When the financial analysis is performed, the risk of fraud should also be considered. The financial analysis should include performing ratio and trend analysis over time and the comparison to the industry and non-financial data. The objective is to identify unusual relationships that might suggest errors or irregularities. Of particular importance is an analysis of the statement of cash flows, looking for unusual relationships. For example, over time are there significant accrual earnings but only minimal or negative cash flows from operations?

Other examples, which may indicate financial statement fraud, could include significant increases in accounts receivable and inventory balances and, coincidently, extraordinary increases in gross or net profits. Costs deferred and recorded on the balance sheet as an asset (based heavily on management’s judgment) may provide management the opportunity to aggressively defer the recognition of expenses, resulting in increased profits. Significant declines in gross margins in businesses that handle a lot of cash, such as restaurants and liquor stores, can be an indication of individuals misappropriating or “skimming” cash. It would be very important for the investor or turnaround professional to make sure a system of internal controls exists, which would assist in the prevention or detection of fraud in these situations.

YOU’LL NEVER MEET A FRAUDSTER YOU DON’T LIKE: BEHAVIORAL CUES OF FRAUD

Management and employee behavioral red flags include:

- An employee’s unusually close association with a vendor or customer.
- A wheeler-dealer attitude of management.
- Excessive pressure from within the organization to meet profit objectives.
- Someone living beyond their means.
- A person in a position of responsibility or access to assets who is unwilling to share duties.
- Someone’s refusal to take vacations.
- An employee’s addiction or financial problems.

Of course, these red flags do not prove fraud exists, but they do provide an indication of areas for concern. Investors and turnaround professionals are not fraud examiners but should realize that businesses in trouble, in transition, or with other characteristics of high fraud risk can provide an environment that is conducive to fraudulent conduct.

Unfortunately, behavioral red flags do not always exist. There is a saying among fraud examiners: “You will never meet a fraudster you don’t like.” Employee fraud is often
committed by long-term, well-liked, and well-respected employees. My first involvement with a fraud scheme occurred when I was a young staff auditor for a national auditing firm. I had the job of sending out confirmation letters to customers of the company under audit in order to independently confirm the balance that customer owed at year-end. I needed help stuffing the envelopes and an employee of the company volunteered. He was, in my opinion at the time, the most personable, likable, sharpest-looking, and presumably the most intelligent person that I met at the company. He asked me all sorts of questions regarding what it took to be a CPA and what an audit entailed. He also asked if he could bring the confirmations to another room to stuff the envelopes because of some business he needed to accomplish. Of course, I did not let him leave the room as I had to have complete control over the confirmations or it would have compromised the audit procedure. (The individual could have pulled out the customer accounts he didn’t want to go out and signed them and mailed them back to the auditor without any exceptions.)

When the customers returned the confirmations, a number of them disagreed with the balance the company said the customer owed. It turned out that the individual helping me was a sales manager who would meet the customers when they picked up their purchased merchandise at the warehouse and ask the customer for their check for payment. The sales manager kept the checks and deposited them in his own bank account. However, he had not been able to adjust the company’s customer accounts receivable balances to remove unpaid balances and, as a result, got caught. Although the sales manager’s scheme was unsuccessful, I will never forget how impressed I was with this fraudster before I found out what he did and how misleading perceptions of people can be.

DECREASING THE CONDITIONS FOR FRAUD

Investors or turnaround professionals often assist or act as management to improve operations of the acquired business or, if troubled, turn operations around from bad to good. However, at this point, if they have not detected the likelihood of fraud, the question they need to ask next is, “Am I setting up the motivation and opportunity for fraud?” Among fraud examiners, the conditions that tend to be present when fraud occurs are described as, “the fraud triangle.” The three points of the fraud triangle are: motivation, opportunity, and rationalization.

What are the conditions that can increase the motivation, opportunity, and rationalization to commit fraud? Compensation based upon divisional or company performance, or unrealistic expectations of shareholders or banks, can motivate management to fraudulently misstate financial statements. Business owners, in an attempt to obtain the highest value for the business they are selling, may be motivated to artificially increase earnings. When an investor buys a business, the employees may want things to look good to the new owner and begin to manipulate earnings. Or the employees want to “get what’s theirs” before the new owner makes too many changes or understands the business completely.

Opportunity can be provided by management overriding internal controls to make fraudulent entries that artificially increase quarterly earnings for a publicly held company. Businesses that deal with a lot of cash, or easily marketable and valuable assets, are always at risk if internal controls are not present to reduce or eliminate the opportunity for employees to misappropriate these types of assets.

Management can rationalize fraudulent entries by saying to themselves that earnings will improve next quarter and the fraudulent entries will be reversed and “none will be the wiser.” Employees can easily come up with rationalizations such as perceived under-appreciation of their value by management or not getting their “fair share” of the sale proceeds of the business sold by the owner.

Normally, all three conditions in the fraud triangle must exist. However, just because one condition doesn’t exist, doesn’t mean fraud will not occur. For instance, significant pressure may cause an individual to commit fraud even if an easy opportunity doesn’t exist.

CREATING FRAUD PREVENTION AND DETECTION SYSTEMS

Investors or turnaround professionals must be careful, as they implement programs to reduce costs and improve profits, that the conditions described in the fraud triangle don’t come into play and set up an environment that effectively increases the probability of fraud. Systems should be set up to aid in fraud prevention and detection. A useful tool to assist with this is Managing the Business Risk of Fraud: A Practical Guide, published
by The Institute of Internal Auditors, The American Institute of Certified Public Accountants, and the Association of Certified Fraud Examiners, 2008.2

This publication provides guidance on how to properly address the risk of fraud in an organization. It includes principles related to governance issues, fraud risk assessment, prevention, and detection and investigation actions with respect to allegations of fraud. It suggests that the organization should put a fraud risk management program in place that includes developing processes and procedures:

• For fraud risk management oversight and expectations of the board of directors and senior management regarding managing fraud risk.
• To identify and evaluate the risk of fraud occurring.
• To prevent and detect potential key fraud risks.
• To manage fraud exposure.
• For receiving input on potential fraud and reporting allegations of fraud.
• For a coordinated approach to the investigation of potential or alleged fraud and the use of corrective action to assure these potential fraud issues are addressed.

An important part of any fraud risk management program is the fraud risk assessment. This is an assessment of where the greatest risk of fraud exists including specific potential fraud schemes and events that the business needs to mitigate. Critical question must the asked:

• How might weakness in the system of internal controls be exploited?
• How could existing internal controls be circumvented or overridden?
• How could the fraud be concealed?

The fraud risk assessment begins by gathering information to identify all types of fraud schemes and scenarios that could occur, and the incentives, pressures, and opportunities to commit fraud specific to the subject business. For example, what types of fraud schemes could occur related to the misappropriation of cash? A retailer might focus on point-of-sale transactions. A manufacturer making credit sales might focus on the accounts receivable payment application process.

This fraud risk assessment would also include other types of fraud such as corruption or financial reporting fraud.

The next step in the fraud risk assessment includes determining the likelihood and potential significance of these identified fraud risks. For example, for identified potential fraud schemes related to the retailer’s point-of-sale transactions, assessment should be made as to how likely it is that employees would misappropriate cash and the potential magnitude of losses. This assessment could be based upon past experience of that retailer or similar businesses, the prevalence of this type of risk in the industry, and discussions with appropriate individuals with respect to the opportunities and motivation for these types of fraud. It also would include an assessment as to the incentives and pressures on individuals and departments to determine which are most likely to have an incentive to commit fraud. A similar assessment of the likelihood and significance of the inherent fraud risk would be made by the manufacturer relating to the accounts receivable payment application process.

Assessing the significance of fraud risk includes not only the dollar effect of the potential fraud but what effect it could have on the business, including its reputation, operations, and possible criminal, civil, or regulatory liability.

After identifying the population of fraud risks that could apply to the business and the relative likelihood and potential significance of identified fraud risks, a plan is developed to deal with those that are determined as most likely to occur and having the most significant inherent risk. That plan to address these risks includes a cost-benefit analysis of the fraud risks and specific internal controls, fraud prevention, and detection procedures. Anti-fraud procedures related to the organization overall can be adopted, such as performing background checks, anti-fraud training, and instituting a confidential whistleblower hotline for employees to call to report suspected fraud or other illegal activities.

Specific process controls are identified that are designed to detect or prevent the most likely fraud scenarios. The more significant the risk of fraud, the greater the required level and extent of the controls. For the retailer’s point-of-sale transactions, controls could include reconciliation of the cashier’s cash drawer to the cash register at the end of the shift, and review and testing of the reconciliation by another authorized employee. In addition, controls would require approval of any
over-ring adjustments and the use of security cameras. Examples related to a manufacturer’s accounts receivable payment application process could include segregation of duties so the individual recording receivable payments never has access to customer checks. Additionally, any customer account adjustments or write-offs must be approved by another authorized employee outside of the payment application process area.

After these fraud prevention and detection procedures and processes are selected and implemented, the business must continually monitor the controls to make sure they are being followed and are working effectively. Any deficiencies found must be fixed in a timely manner. Fraud-related statistics should be kept to measure whether these control processes and procedures are working effectively.

Managing fraud risk is not an academic exercise. Any owner or management of a business that has been affected by a material fraud will tell you that they wish they had had a better appreciation of the negative impact fraud can have on an organization and how allocating more thought and resources to fraud prevention and detection would have saved the organization significant headaches and expense.

No one expects investors or turnaround specialists to be fraud examiners, but they should have an awareness of fraud. This will assist with managing the risk of fraud when becoming involved with a new, changing, or troubled business and also in preventing the unintended potential consequence of encouraging fraud when setting programs to improve operations. As the old saying in the medical profession cautions, “First, do no harm.”

ENDNOTES


To order reprints of this article, please contact Dewey Palmieri at dpalmieri@iijournals.com or 212-224-3675.
A reduction in force (RIF) or layoff is never a pleasant option, but it is sometimes a necessary one. Particularly in times of economic downturns, small and large employers alike are at risk of facing the need to reduce their workforce. Ineffectively planned and poorly executed RIFs can produce a host of negative, unintended consequences that can be devastating for employees, management, and the organization itself. The process is a complex one that involves a multitude of issues involving technical tasks, legal considerations and potential litigation, financial concerns, human issues and emotions, communication requirements, security questions, and the health of the “new” organization after the layoffs are completed.

To assume that effective, legally defensible, and business-savvy decisions can be made “on the fly” in the midst of such a challenging, stressful, and emotionally charged environment suggests gross naiveté, foolishness, or unparalleled arrogance. Regardless of whether a layoff is even on the company radar, responsible employers are wise to plan for the eventuality. Planning in advance affords the organization a considerable opportunity to plan and structure the layoff carefully to:

- Minimize the prospects of litigation.
- Reduce the negative impact on employees—both those who are laid off and those who remain.
- Decrease disruptions to the company, its employees, and customers, and to the larger community.
- Build the trust, respect, support, and goodwill necessary for the future of the organization following the layoff.

A step-by-step process of planning and executing a RIF requires analysis and discussion of a variety of areas. While the legal considerations are numerous, this article will outline the basics of layoff planning while focusing more extensively on two major areas: selection of candidates for layoff and communication programs.

ADVANCE LAYOFF PLANNING

Layoff; reduction in force; downsizing; rightsizing. Regardless of the term used, its mere mention produces anxiety, fear, and a deep sense of dread. And that’s only among the executive management team as they come to the realization that a RIF is necessary! Those involved in the restructuring industry may view the layoff process as one that can be somewhat standardized. However, the process is far from routine, and every situation is truly unique. As word of a possible layoff makes its way to the general workforce, employees not only fear the loss of their job, income, and lifestyle, but also face the resultant uncertainties regarding what the future may hold.
Will an equivalent job be available? Will the next job come before bank foreclosure on their home? What about medical insurance? Do they have the skills to compete in today’s marketplace? Is job training available?

WHY IS PLANNING IMPORTANT?

The loss of a job can bring devastation, both in emotional and financial terms, for employees and employers alike. Sound business decisions that are legally defensible—and that produce as little personal and corporate turmoil as possible—are difficult to make in such an emotionally charged atmosphere. Further, an employer implementing a RIF must consider “a myriad of technical considerations, legal issues, and human issues, all within the context of an extremely difficult environment” (Pfadenhauer [2007], p. 18). This is one of the primary reasons that thorough advance planning is essential, and conversely, is perhaps also a significant factor in the tendency for “so many otherwise first-rate executives [to] ignore the signs pointing to a layoff until it’s too late to plan adequately” (Downs [2006]).

Planning should begin, at the latest, as soon as the possibility of a reduction in force surfaces. Ideally, plans should be completed well before they are needed with review and possible updates necessary only if/when an organization faces workforce reductions. Planning frees those responsible for conducting the layoff from making difficult decisions during a time when emotion, tension, and uncertainty render them less than effectual decision-makers. They simply pull the established plan and begin work to implement its components.

That is not to say that having a solid RIF plan in place will totally eliminate any emotion, anxiety, tension, or other difficult issues associated with a layoff. It won’t. A layoff is a tough and sensitive process that no one welcomes. However, planning will allow organizations to avoid many of the major pitfalls of layoffs. It provides a mechanism for establishing a disciplined approach to addressing these critical factors:

• How employees will be selected for layoff.
• Length of notice to be given.
• How and when the layoff will be communicated to various stakeholders including management, employees, vendors, and the local community.
• Whether/how much severance pay will be involved.
• What role, if any, the company will play in assisting with job searches or education/re-training.
• What the company will look like after the layoff.
• How to minimize the likelihood of legal actions by employees who lost their jobs or union activity among remaining employees.

How well (or poorly) such crucial decisions are made and implemented have a fundamental influence on the lives and futures of laid-off employees and on the future of the company. RIFs should never be conducted with a “learn as you go” approach (Sullivan [2001]).

10 BASIC STEPS FOR EFFECTIVE LAYOFF PLANNING

Planning effectively for a reduction in force requires a disciplined and comprehensive approach along with a commitment from all participants to invest the time and effort essential to developing a solid plan. The plan must be based on current, reliable information and address all foreseeable issues that will, or could be, encountered before, during, and after the layoff.

Documentation of the process and the timing of decision-making are also imperative. This is particularly true in terms of when the decision to carry out a layoff is made. Should union activity (or another similarly protected activity) take place subsequent to the decision but prior to its actual implementation, such documentation can be crucial in establishing that the decision to conduct a layoff was made prior to the protected activity and was not a retaliatory response (Segal [2001]). Laying the foundation for the plan entails answering two preliminary questions:

• Is a reduction in force necessary and, if so, why?
• Who within the company will serve on the planning committee?

Step 1: Determining whether a Layoff is Necessary

This step involves making a determination as to the underlying problem(s) and evaluating alternative options. Are there feasible alternatives to a layoff that could reasonably be expected to correct the financial issues? Making a thoughtful determination of the necessity of a layoff allows the company to avoid making an impulsive decision that could result in “throwing away valuable talent...
and organizational learning … reducing the efficiency of remaining resources … [and] the potential for future growth” (Downs [2006]) when other, less extreme and damaging measures may have been suitable, and it also increases the legitimacy of the reasons for a layoff, if that course is decided upon. Once the decision is made that a layoff is in fact required, the timing of this decision and the reasons the layoff is necessary should be documented.

**Step 2: Deciding Who Will Participate in Planning the Layoff**

This step may involve establishing two work groups or committees: one smaller group to conduct the overall planning and a larger, diverse group to develop the criteria for determining how employees will be identified for layoff.

On the other hand, the organization may determine that a single group with both organizational and cultural diversity (gender, race, age, etc.) is suitable for both tasks. The composition of this group is critical to the success of the planning effort and ultimately to the implementation of the layoff plan. It is important to include representatives from each area of the company in order to have those varying perspectives at the table and to allow employees in each area the reassurance that their department/division has representation as crucial decisions are made. Further, this serves to allow managers some “ownership” of the process, without which comes the temptation to blame everyone else when there are problems or if the layoff fails to achieve its desired results (Sullivan [2001]).

It is equally important to have diversity in terms of age, gender, race, and any other protected group in order to benefit from the perspective of varied backgrounds and experiences. Such diversity can also minimize later contentions that employees from a protected group were selected because they were not represented on the committee establishing the criteria for layoff decisions. Segal [2001] makes some noteworthy observations in regard to the diversity of the committee:

1. Members should not be selected to serve on the committee solely because they are in a protected group. Selecting unqualified individuals on this criterion alone can be detrimental to the planning process and may backfire in litigation.
2. Since the top management group of the organization typically serves as the pool from which committee members are selected, and diversity among the members of the committee is important, companies without adequate diversity in management begin the process at a disadvantage.

It is imperative to include in the committee the CFO or designee, HR representation, the corporate attorney, and a union leadership representative (particularly in setting the criteria for selecting employees for layoff), if there is a union involved. Companies without a staff attorney should consider hiring an attorney specializing in employment law as a consultant for the layoff process, as there is a myriad of legal issues that must be evaluated and appropriately addressed and laws with which to assure compliance. The attorney’s inclusion reduces the likelihood of subsequent litigation and, should litigation be faced, affords a legal expert familiar with the decisions made throughout the process.

Again, the group responsible for the overall layoff planning should be as small as possible, but still have appropriate representation. The diversity of representation is particularly critical when it comes to developing criteria for selecting employees for layoff. Should the group become large enough to impede timely and effective completion of the overall planning process, it may be prudent to utilize two groups: a smaller subgroup responsible for the overall process and the larger group involved specifically in the task of developing layoff criteria. One individual—perhaps a senior manager—should be identified to lead the group, guide the process, and ensure the group has all necessary information and resources.

**Step 3: Determining What the New Organization Will Look Like After the Layoff**

This is a key step and lays an important foundation for developing selection criteria. Skipping this vital step handicaps the organization in determining what staff will be needed after the layoff and prevents development of a clear vision of the future of the organization. Without these requisite tools, the problems of the past are more apt to be repeated and “will be likely to sabotage the future and create a cycle of repeated layoffs with little improvement in organizational efficiency” (Downs [2006]).

During this process, it is essential that the committee look at the new organizational vision, goals, and structure
in terms of what the company will be doing—what services and/or products—and what skills, knowledge, and experience will be required to accomplish the goals of the new organization. The focus must be on the positions themselves, not on people who may currently be in these or similar positions. Making decisions in this manner allows a higher degree of objectivity and reduces the likelihood that discriminatory decisions—or decisions that could be perceived as discriminatory—will be made (Segal [2001]). In addition, focusing on the positions, the position responsibilities, and the skills, knowledge, and experience required to perform effectively in the position is invaluable in determining what responsibilities those remaining after the layoff will be expected to take on and what new skills they may need to learn in order to do so.

A new organizational chart should be developed depicting remaining departments and their structure along with positions in each area. In cases where job responsibilities will change as a result of the revised company vision and focus, job descriptions should be revised to reflect those changes (Segal [2001]).

**Step 4: Setting a Target Date for Implementing Layoff**

This step is not as complex as many of the other steps, but it is an important one. Factors to consider include the level of urgency in terms of the company’s financial condition and the need to make an effort to avoid “key business peaks, major holidays, and vacation periods (both because of the inconvenience and the potential negative PR issues)” (Sullivan [2001]).

**Step 5: Determining How, When, and What Information Will Be Communicated to Stakeholders**

The importance of appropriate communication both within and outside the company cannot be overemphasized. Stakeholders will always get information somehow—some accurate and perhaps even more that is inaccurate or at best incomplete. It is vital that they hear first from company officials with accurate information, to engender positive perceptions and avoid the perception that something is being hidden, leaving a sense of distrust and disrespect. This step should also include the development of written resource materials, particularly an information packet for those being laid off that answers frequently asked questions, provides contact information for company departments and outside agencies available to assist them, and provides information regarding any specific help available in terms of job searches and/or education or training opportunities.

**Step 6: Identifying and Addressing Security Issues**

This involves both internal and external concerns in regard to employees and competitors.

**Step 7: Developing a Layoff Budget**

The budget provides detailed information regarding the costs associated with the reduction in force and should include all costs directly attributable to the process. Identification of costs is important not only to the process at hand, but to the future finances of the organization subsequent to completion of the layoff. Although the budget amount should be as reasonable as possible, it must also accurately reflect the true costs of planning, implementation, and follow-up. Costs to be considered in the layoff budget include, but are not limited to:

- Payments to consultants or attorneys.
- Costs associated with development of printed materials.
- Any overtime associated with planning processes if nonexempt employees participate.
- Severance packages.
- Unemployment claims.
- Benefit payouts.
- Reduced productivity.
- Potential litigation costs.

**Step 8: Reviewing Contractual Agreements and Employee Benefit Plans**

This ensures that the employer is aware of any contractual obligations that may limit the employer’s RIF options and will help it identify any communication requirements under these plans. Examples include “individual employment contracts, collective bargaining agreements, written severance plans, or employee handbooks that may arguably commit the employer to following a particular procedure” (Erwin et al. [2006]) or particular benefits for employees terminated by the company.
Step 9: Reviewing and Planning for Compliance with Legal Requirements

This is a crucial step in the planning process and must be undertaken with care and attention to detail. Failure to adequately address this aspect of planning can be very costly to the company in terms of both the costs of litigation and the company’s reputation. Many of these issues are related to the notice given to employees and the treatment of protected groups.

Step 10: Defining the Selection Criteria for Persons to Be Laid Off

This is perhaps the most difficult of the planning steps. It is also, however, one of the most significant—some might argue the most significant—in terms of its impact on individual employees, the future of the organization, and its potential for giving rise to claims of discrimination.

SELECTION OF CANDIDATES FOR LAYOFF

As noted in Step 2, the group charged with developing the criteria for selecting those who should be eliminated in a layoff should have both organizational and cultural diversity, reflecting the demographics of the workforce. This diversity not only allows for consideration of differing perspectives, but provides representation from all areas of the organization and from various groups, some with protected status, throughout the company. Representation on the committee developing the selection criteria can reduce the potential for claims of discriminatory treatment of group members.

A variety of approaches, or combinations of approaches, may be used to develop selection criteria. The more objective the criteria is, the better. Using subjective criteria to determine who stays and who goes has clear inherent risks and provides no defensible basis for justifying decisions and countering subsequent claims of discrimination. Organizations that developed a clear vision of what the post-reduction company would look like in Step 3 of the planning process will have a clear advantage over those that disregarded, minimized, or underestimated the importance of this part of the planning. Such organizations will have created for themselves an indispensable tool for guiding the selection process and a solid foundation on which to build a more objective system of criteria to both accomplish the goals of the reduction in force and ensure appropriate staffing as the organization moves forward. The importance of diligent, conscientious, and systematic preparation in this area cannot be over-emphasized.

Seniority

The method that is perhaps the simplest, most clear-cut, and least likely to result in claims of discriminatory treatment is that of seniority. There are advantages to the “last-in, first-out” approach, and its simplicity can be particularly attractive to those overwhelmed with the number of complex issues and decisions they are facing with the layoff process. The criterion of seniority is objective and may reduce the risk of union activity resulting from the layoff as unions typically promote seniority as a key criterion (Segal [2001]).

But despite its simplicity and objectivity, selection solely on the basis of seniority is not without disadvantage or risk. It may result in the sacrifice of exceptional, less-senior employees who would benefit the future organization far more than senior employees performing at a substandard level. Even with its high degree of objectivity, seniority does not necessarily provide full insulation against claims of discrimination since more recently hired employees often include protected groups such as women and minorities (Erwin et al.).

Job Elimination

Job elimination, when based on the clearly defined needs of the future organization, provides another objective, justifiable criterion. Eliminated positions may include those that have become obsolete as a result of technological advances, products or services that will no longer be offered, or functions that will be outsourced in the restructuring of the organization. Use of this criterion in an objective manner requires (again) that thoughtful and thorough planning for the “new” organization was undertaken and included the development of a new organizational chart; explication of positions, skills, and experience required in the new organizational structure; and revision and/or creation of new job descriptions as indicated. In addition, when focusing on job elimination as a method of reducing staff, consideration must also be given to the use of
bumping in order to reduce the problems that can occur with the loss of institutional knowledge.

**Performance-Based Criteria**

Performance-based criteria, though highly desirable from a business perspective, can be fraught with risks for subjectivity, discrimination, or disparate-treatment claims. When conducted properly and systematically, the business benefits of utilizing performance considerations may outweigh those risks (Segal [2001]). The effectiveness and level of objectivity of using performance criteria are highly dependent on the quality of the organization’s performance appraisal system, consistency in supervisory application of the system, and whether the skills evaluated are congruent with those crucial to the new organization’s success.

A numerical ranking system may be beneficial since existing performance appraisals typically do not evaluate an employee’s performance relative to that of other employees. Factors considered for ranking must be well defined, clearly linked to position responsibilities, and documented with as much objectivity as possible. Some factors are more quantifiable, and thus more objective, than others. Average monthly sales or the quantity of items produced, for example, are readily quantifiable.

Subjective behavioral factors such as those involving interpersonal skills are much more difficult to quantify. However, employees with adequate or superior job knowledge and technical skill may perform poorly due to factors considered to be more subjective in nature (e.g., ability to work collaboratively with others, communication skills, adaptability in environments of change) and thus present a hindrance to the success of the organization. The level of subjectivity of these factors can be decreased with appropriate documentation including specific, concrete, and objective examples of behaviors. Such documentation increases the probability that decisions giving rise to perceptions of inequity can be evaluated and vindicated (Erwin et al. [2006]). Employers must weigh the legal risk of using these factors against the business risks of not using them (Segal [2001]). Related questions that should be considered and answered in advance include how employees’ performance has declined significantly or dramatically improved since the last appraisal (Segal [2001]) and how those for whom a performance review is not available (Smith [2007]) will be handled.

**Cost Reduction**

Cost reduction, certainly a factor in most RIFs, can also be used in the selection process, but employers should do so judiciously, with caution, and only after thorough consideration of the impact on older workers as a group. Although it may be desirable to eliminate positions with very high salaries, workers over the age of 40 often hold such positions and are thus members of a protected group. Should such positions be eliminated, employers may wish to consider allowing the older workers with extensive work experience who held these positions to “bump” a younger, less experienced worker in a position with lower pay (Segal [2001]).

**Multiple Criteria Strategies**

Using multiple criteria as opposed to a single criterion enhances the strength and validity of the decisions made in determining which employees will be laid off. Particularly when using assessments of performance that may be weak individually, multiple assessment methods (performance appraisals, data from customer feedback systems, 360-degree assessments, skill evaluations, team/peer evaluations, etc.) increase the strength and objectivity of performance rankings (Sullivan [2001]). It is preferable to compile existing assessment data than to develop new assessment tools solely for the purpose of layoff selection, to avoid the perception that evaluations were “rigged” or manipulated to support predetermined decisions.

Methods of selection, such as performance ratings and seniority, may also be applied in combination to make layoff decisions. For example, performance may be utilized as an initial method of selection, with employees having unsatisfactory performance appraisals and/or formal performance-related disciplinary action being eliminated first, with seniority applied as the determining criteria for remaining employees (Segal [2001]).

Once the criteria for selection are established, implementing them effectively and uniformly is as important as choosing them. When the group meets to make layoff determinations, the criteria must be consistently applied—ideally with no exceptions made, or at least made only rarely and for legitimate, defensible reasons that are identified prior to layoff determinations. A single individual should be identified to record decisions (not comments/discussion preceding decisions).
reached during the meeting (Segal [2001]). If numerical rating systems are used, scores should be rechecked to avoid arithmetic errors that could lead to erroneous identification of employees for layoff.

AVOIDING DISCRIMINATION CLAIMS

After selection criteria have been applied to make preliminary decisions, the results should be evaluated to determine whether there is an adverse impact on protected groups prior to finalizing a list of employees to be laid off. Statistical analysis allows the employer to identify any group disproportionately impacted by the process, address any issues revealed, and assure documentation of any changes made. Determining whether statistically significant differences exist despite the use of well-developed and uniformly applied criteria prior to finalizing layoff decisions (rather than in response to discrimination claims) allows the employer to proactively reduce the risk of discrimination and disparate treatment claims (Birk [2008] and Segal [2001]).

Regardless of the criteria established, employers should release temporary workers prior to initiating the selection of “regular” status employees. Organizations may wish to allow employees to volunteer for layoff as well. Additionally, it may also consider implementing an Early Retirement Incentive Program (ERIP) (Hayden and Pfadenhauer [2005]). Both of the latter two approaches can reduce the number of forced layoffs, although they also have the potential to result in the loss of employees the company would benefit from keeping.

THE LAYOFF COMMUNICATION PROGRAM

Beyond the selection process described above, the communication plan can make or break an organizational layoff. Effective communication can help to reduce uncertainty not only for employees but also for customers, shareholders, vendors, and the public at large. Once the decisions are made, the task of developing a comprehensive communications plan needs to be quickly developed and its implementation carefully formulated and monitored.

There are numerous stakeholders that each require carefully planned communication, not only for basic legal consideration such as notification requirements under various state and federal laws, but also to ensure, for example, ongoing employee commitment, customer loyalty and vendor cooperation. Beyond the basic elements of communication, each stakeholder’s needs and concerns must be anticipated and the communication tailored around these needs. It goes without saying that the communication programs must be developed in such a way that they remain truthful, yet positive and flexible, yet clear and predictable.

Stakeholder Concerns

Employees are typically concerned about the continued viability of the organization, the maintenance of the same level of pay and benefits, job design issues, and general issues of uncertainty and distrust of management. Labor unions are concerned with similar issues, but with a focus on maintaining union membership and corresponding dues. Issues surrounding the layoff may likely be subject to negotiation between the employer and the union.

Customers and vendors are likely concerned about quality, delivery, payment, and timing issues. In certain instances customers are also concerned about reputational issues as members of the community at large. It is not uncommon for an organization that has treated its employees poorly to experience the public’s wrath through criticism and boycotts. Nor is it uncommon for vendors to communicate with customers or for employees to communicate directly with either of these groups. Thus, the “grapevine” goes well beyond internal communications among employees.

Shareholders, senior management, and board members are often concerned about legal compliance, reputational issues, and continued viability of the firm, and that the contemplated reduction in force will cure what ails the firm.

Methods of Communication: Written and Spoken

All and spoken written communication must be vetted by human resources experts, legal experts, and marketing/communications experts. In addition, while the human resources professional is focused on employee impact and the operations team is focused on productivity and quality, each must be sure that any communication is assessed from their viewpoint before release. Ideally, the committee representing the organization utilized in the selection process will also participate in the communications process. Every piece of information
shared with the public (including employees) must be carefully reviewed for its perception and impact on each of the stakeholder groups. Questions must be anticipated and corresponding answers must be developed and agreed upon. Those who are authorized to speak on the subject of the layoff must be identified and their identity and contact information disclosed to others.

Organizations are best served tailoring communication slightly differently for management and employees. While it is not at all uncommon to argue that everyone should hear the same thing, it is important to consider the specific needs of supervisors. They are the ones that employees will immediately go to after the announcement is made with further questions. Given the opportunity to ask questions in a large open meeting format among all of their fellow employees or the choice of asking a supervisor privately or in a small group setting, the employee will likely choose the latter. An organization that focuses also on management education and support will minimize the effects of the grapevine when managers can communicate in an approved fashion rather than becoming part of the grapevine themselves.

All written materials that are necessary for the announcement should be available at the announcement. If there are legal notice requirements that apply to the contemplated layoff, these should obviously be reviewed by legal counsel and by internal personnel so that they incorporate the tone that management wishes to set. The communication plan should also take into consideration those individuals who are on a leave of absence, those in remote field locations and other time zones, and those who work alternate shifts.

**Meetings**

All meetings must be carefully staged. Consideration should be given to both holding meetings onsite, and holding them offsite for logistical or security concerns. Each presenter must be provided with approved talking points and should be given a list of anticipated questions and their corresponding approved answers. Where answers are not available, that fact should be made clear, and the contemplated timeframe of obtaining the answer and how it will be communicated should be considered. Where questions are posed and the answer is confidential, that too must be communicated. Communicating with confidence and authority will go a long way to keeping the organization stable throughout the transition.

Termination benefit programs such as the availability of severance, outplacement, and benefit continuation should also be addressed globally at general announcement meetings. Follow-up meetings with affected individuals should be quickly scheduled to discuss their particular situations. Meeting with survivors to address the effects on the design of their jobs and workflow must be done quickly.

**The Media**

The media can be a useful ally in layoff communications. While media response to an announced layoff can be and often is negative, organizations would be best served to engage the media at the outset in order to tell their sides of the story before erroneous conclusions are drawn with unclear facts and scant information. Particularly in areas where a plant closing could have a significant effect on the local community, the organization can utilize the media to help it communicate information about community support systems it is putting into place, support services for employees and their families, and other useful information that will be perceived positively by local customers or vendors.

The organization should identify those individuals who are approved to communicate with the public, including the media, regarding the announcement and following activities. Internal personnel will always receive inquiries from the media, the public at large, and those who are just plain nosey. They must know who to forward these inquiries to.

**Consideration of Survivors**

At all times, communications programs must anticipate the effects on survivors who will remain with the organization after the reduction. They are vital for sustaining quality, customer service, and vendor relationships. The more uncertain these individuals are, the more likely they will join the ranks of the disengaged and become a significant part of the grapevine. Productivity is sure to plummet and community relations suffer.

**Subtle Communication: What Behavior Communicates**

How the layoff is handled communicates far more than decisions or words. Poorly executed plans...
communicate the extent to which the employer cares about its employees and whether it really is concerned about continuing as a viable entity. Treating employees in a shoddy manner on their way out is likely to foster a great deal of sympathy among survivors, who will translate these unspoken messages as a lack of concern. Were documents and notices handled effectively? Were questions answered in a compassionate and honest way? Were departing employees and their families offered the necessary support to assist them in the transition to unemployment? Is someone available to help guide departing employees and answer questions after they are gone? “Organizations need to take care of terminated employees and must communicate that fact in ways that are credible and noticeable in the eyes of the surviving workforce” (Smeltzer and Zener [1994]).

Monitoring and Controlling the Grapevine

Without proper planning at the front end, the grapevine and related gossip will quickly overrun any communications program. Ensure that managers are trained to identify and address the grapevine when they see it. As part of their management education and support, they must have a place to go with the issues or concerns they overhear or the questions that are posed to them. This step in the support structure is vital.

Ongoing and regular planned communication can be useful in stemming gossip. Yes, everyone will scurry around, discussing each phase in the communication. But if the periodic communication refers to a previously disclosed plan, provides feedback on progress on the plan, and is predictable in its content, listeners are more likely to look forward to such communication and be calmed rather than alarmed. Communicate early and often. Employees should be provided with an honest assessment of how the business is doing and prospects for the future (Pfeil et al. [2003]).

GETTING THE ORGANIZATION BACK ON TRACK

Prior to the transition, the organization must focus on keeping on track. But it also must assign individuals to focus on the long term. They must be the champions for ensuring that the transition is carefully planned and communicated to survivors in terms of the effects on their jobs and workflow. In addition, these long-range planners are responsible for ensuring that planning has taken place to formulate and communicate a new vision for the organization where appropriate.

CONCLUSION

No layoff or RIF can be effective without being conducted in accordance with a detailed and thoughtful plan emphasizing selection and communication. Both of these areas must take into account the effects of the layoff decision on various stakeholders of the organization and the impact that the decisions and resulting communication will have on them. The viability of the organization and employees that remain depends on successful planning and implementation in these two significant areas.

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Recent Case Law on Cross-Border Guarantees

STEVEN J. WEISZ AND BETH E. POSNO

Recent cases decided under the Companies’ Creditors Arrangement Act (CCAA) highlight some potential snare in coordinating U.S. and Canadian insolvency proceedings. In both cases, the Canadian debtors had guaranteed the obligations of their U.S. affiliates, in one case under a secured loan and in the other under a debtor in possession (DIP) loan. These cases illustrate how the Canadian courts are dealing with the issue of cross-border guarantees and the extent to which they are concerned that the interests of Canadian unsecured creditors be considered.

RE InterTAN CANADA LTD., [2009] O.J. NO. 293 (ONT. SCJ)

InterTAN Canada Ltd., together with Tourmalet Corporation (the Applicants), sought and received protection under the CCAA on November 10, 2008, the same day that its U.S. parent company, Circuit City Stores, Inc. (U.S. Debtors) filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code. Circuit City was a major U.S. retailer of electronics that operated the Circuit City chain of stores. InterTAN operated the Canadian chain of stores under the The Source brand.

InterTAN and Circuit City were both party to a secured credit facility with certain secured lenders (the Secured Facility). Although the funding commitments to and repayment obligations of the two debtors were separate under the Secured Facility, the commencement of the Chapter 11 Proceedings by Circuit City constituted an event of default for both entities. This default caused all amounts due by InterTAN under the Secured Facility to be immediately due and payable and triggered InterTAN’s CCAA application.

Circuit City and InterTAN entered into a DIP facility with the same secured lenders (the DIP Lenders) to replace the Secured Facility. There were three notable features of the DIP Facility:

1. The security granted to the DIP Lenders was broader in scope than their pre-existing security under the Secured Facility.
2. InterTAN guaranteed the obligations of Circuit City under the DIP Facility even though InterTAN had no obligation for amounts owed by Circuit City under the Secured Facility.
3. The DIP was a “roll-up.”

The Court will approve DIP financing if it is satisfied that the benefit to the debtor and its stakeholder substantially outweighs the prejudice that would be suffered by the secured creditors who have been “primed.”
The standard form model CCAA initial order already provides that DIP lenders will be granted priority over pre-existing security interests for the DIP loan (including statutory liens and deemed trusts), subject to certain exceptions, and recent case law has confirmed the ability of the Court to so provide. However, in many cases where the existing secured lender is also the DIP lender, the DIP loan will provide for a refinancing of the existing loan. This may involve a “roll-up” where the new advances to the debtor are made under the DIP facility, but payments are made against the pre-existing facility, gradually rolling up the outstanding secured debt into the DIP loan.

To address the fact that the DIP Facility in this case would negatively impact the position of the unsecured creditors of InterTAN in Canada, the DIP Lenders were granted first priority in respect of the amount of borrowings made directly by InterTAN, and a “Canadian Creditor Charge” was created in a specific amount. The Canadian Creditor Charge was designed to give some protection to existing trade creditors of InterTAN. The remainder of any DIP Facility borrowings, including amounts pursuant to the guarantee by InterTAN of Circuit City’s obligations, would then rank below the Canadian Creditor Charge. On this basis, the Court approved of the DIP Facility arrangements and later approved certain revisions to the amount of the Canadian Creditor Charge.

Some months later Justice Morawetz of the Superior Court of Justice heard a motion brought by the monitor in the CCAA proceedings, seeking that the Applicants be ordered not to make any advances to their U.S. affiliates or make any payments to the DIP Lenders except in respect of InterTAN’s direct borrowing under the DIP Facility. The impetus for the motion was the fact that certain orders were made in the Chapter 11 Proceedings that the monitor argued would negatively impact the Canadian proceedings and which had not been approved by the Canadian court. These amendments to the orders provided that 1) the proceeds from certain assets of Circuit City could be retained by it and 2) to the extent allowed by the Canadian courts, 50% of the net proceeds received by the DIP Lenders under their charge would be paid to Circuit City’s estate (and therefore be paid to their unsecured creditors in the U.S.) and not applied in reduction of its obligations under either the DIP Facility or the Secured Facility. These changes applied only to the U.S. debtors and not to the Applicants.

The monitor highlighted in its report to the Court that it and the Court had been advised during the initial CCAA application that the scope of the security was a condition precedent to the DIP Lenders’ provision of the DIP Facility and that without it the Applicants and the U.S. Debtors would fail. Justice Morawetz himself noted that, “In the circumstances of this case, the granting of the DIP Facility, in the form requested, was extraordinary relief.” The monitor pointed out that relief that had once been described as “essential” had been bartered away to the unsecured creditors of the U.S. Debtors to settle their complaints.

Justice Morawetz noted that the other consequence of this change would be to potentially reduce the recoveries by the DIP Lenders in the Chapter 11 Proceedings and therefore increase the likelihood that they would look to the security over the Canadian Applicants’ assets. The Applicants and the DIP Lender advised the Court that this was not their intention and that it was intended that to the extent that the DIP Lenders did not claim the proceeds over the excluded assets, there would be a corresponding reduction in the U.S. Debtors’ obligations under the DIP. However, there was no documentation to support this claim, and the final order granted in the Chapter 11 Proceedings did not reflect this.

The monitor was concerned with respect to the second amendment to the DIP orders because it could potentially give unsecured creditors of the U.S. Debtors indirect access to the Applicants’ assets, which they had not been entitled to before the commencement of the Chapter 11 Proceedings. As a result, this would frustrate the purpose of the Canadian Creditors Charge and deprive the Applicant’s unsecured creditors of potential recovery, while the unsecured creditors in the U.S. would increase their recovery.

In opposing the motion, the DIP Lenders argued that they had already relied to their detriment on the changes to the DIP Facility, having forwarded millions of dollars in advances to the Applicants and the U.S. Debtors over the holiday period. They also argued that any further amendments would put the Applicants in default under the DIP Facility and that this would create uncertainty in the market for future DIP arrangements. On a more principled basis they also argued that their claim could be assigned, sold, or negotiated as they saw fit, since they were entitled to their claim as set out in
the agreements and orders already made. They argued that their ability to deal with those rights should not be changed retrospectively. They also argued that the compromise that they had made with the unsecured creditors of the U.S. Debtors was necessary and that such a compromise had also occurred in the Canadian proceedings in the form of the Canadian Creditors Charge. The Applicants supported the position of the DIP Lenders.

Justice Morawetz had little sympathy for the arguments of the DIP Lenders, noting that there had not been a common approval process and that all of the parties recognized that the courts in both jurisdictions had to approve the common DIP Facility. Justice Morawetz agreed with the monitor’s objections, stating: “In my view, it is not appropriate to provide court approval to the entire package and then tacitly approve of the unilateral activities of the DIP Lenders in discharging portions of the collateral to the potential detriment of certain stakeholders in the CCAA proceedings.” In addition, Justice Morawetz did not agree that the DIP Lenders had the unilateral ability to discharge portions of the collateral package to the detriment of other creditors without court approval. As for the argument that the DIP Lenders had relied on the amendments to the DIP Facility to their detriment, Justice Morawetz viewed this as the fault of the DIP Lenders and other parties for essentially ignoring the CCAA proceedings and found that his endorsement of the order requested would not constitute an event of default under the DIP Facility. The Applicants were ordered not to make any payments to the DIP Lenders except in respect of their own indebtedness and not to make any advances to any U.S. affiliates for the time being.


In this case, a group of seven companies (the SemCanada Group) filed for protection from their creditors under the CCAA. The SemCanada Group was part of a larger group of companies (the SemGroup), including the parent company, SemGroup L.P., and its direct and indirect subsidiaries in the United States (the U.S. Debtors). Shortly before the SemCanada Group sought creditor protection in Canada, the U.S. Debtors had filed voluntary petitions to restructure under Chapter 11 of the United States Bankruptcy Code.

While two members of the SemCanada Group were attempting to reorganize, three of the members (the SemEnergy Group) were in self-liquidation and had no significant ongoing operations. The SemEnergy Group applied for an order authorizing an interim distribution of funds to a banking syndicate, their major secured creditor under a guarantee of the indebtedness of the entire corporate group. The unsecured creditors of the SemCanada Group objected to the application on a number of grounds. The court eventually accepted certain of the objections of the unsecured creditors, namely that 1) there was a possibility that the unsecured creditors would be prejudiced by the interim distribution, and that such potential for prejudice outweighed the benefits of an early payment on the guarantee, and 2) the application was premature and without urgency.

The Court noted that it did not appear that there would be insufficient assets in the U.S. estate to fully pay the lenders. The unsecured creditors submitted that, if the interim distribution was to be authorized, an inequitable situation could arise whereby the SemEnergy Group would have applied all of its assets to the secured debt, leaving its unsecured creditors without the possibility of recovery, while other debtor companies, including the U.S. Debtors, would have their burdens reduced, making it possible that U.S. unsecured debtors would benefit disproportionately. The lenders argued that the guarantee was an unconditional guarantee, and the lenders were not required to exhaust their remedies against any other party before invoking its provision against the SemEnergy Group. However, the Court held that the contractual rights of the lenders were stayed by the CCAA proceedings, and that the rights of a secured creditor are not awarded a unique status under the CCAA.

The lenders submitted that the interim distribution would not prejudice the SemEnergy Group’s other creditors because the SemEnergy Group had rights of indemnification and subrogation against the other members of the SemGroup. However, the Court was concerned about the ability of SemEnergy Group to enforce its rights of indemnification and subrogation. The Court noted that SemEnergy Group’s rights of subrogation and indemnity might not be enforceable against other borrowers or guarantors unless and until all the indebtedness to the lenders was paid in full, and it was not possible to say with certainty that the reorganization of the SemGroup would result in the repayment of...
indebtedness to the lenders in full or in such a fashion that the limitation upon subrogation would not be triggered. For example, a reorganization could compromise the claims of the lenders or could have them continue the loans on revised terms to a reorganized corporate group. The Court also noted that the right to contribution from other members of the SemGroup could be limited under U.S. law to amounts that would not result in the insolvency of such an entity in proportion to such entity’s net worth. Accordingly, the SemEnergy Group’s right of subrogation and indemnity could prove to be a hollow or inadequate remedy.

While the Court made it clear that interim distributions may be authorized in CCAA proceedings, the Court is required to consider the advantages, disadvantages, and potential prejudice of such an interim distribution to all the stakeholders of the debtor entity prior to authorizing such a distribution. The Court satisfied itself that an interim distribution to the lenders gave rise to the possibility that unsecured creditors might be prejudiced and that such potential for prejudice outweighed the benefits of an early payment on the guarantee to the lenders. The Court held that there was no urgency and that it would be prudent to delay an interim distribution until there was sufficient information to better evaluate the potential prejudice to Canadian creditors. The application was held to be premature, and was adjourned sine die with leave to the SemEnergy Group and the lenders to reapply with more current information if it became apparent that the potential prejudice identified to the unsecured creditors was unlikely to materialize or could be avoided by other measures, or that the balance of prejudice and benefit had shifted.

LESSONS

The most obvious lesson from the InterTAN case is that it is dangerous to ignore the Canadian process in cross-border proceedings and that coordination between the U.S. and Canadian proceedings is key. If the facts change, it is prudent to seek court approval and not to assume that Canadian approval is not required, particularly if the facts that have changed were the basis of a previous order in the Canadian proceedings.

The roll-up DIP is a particularly sensitive issue. Unsecured creditors in particular may object to this type of DIP loan structure, and the Canadian courts will likely be very sensitive to this issue going forward, particularly in the context of a new cross-border guarantee. The continued use of this mechanism is in question in any event, as pending amendments to the CCAA prohibit the court from granting a court-ordered charge to secure pre-filing debt.6

There is obviously going to be some sensitivity with respect to cross-border guarantees going forward, particularly when the Canadian affiliates were not liable for the obligations of the U.S. affiliates before the insolvency proceedings were commenced. This is particularly the case when the various estates are going to be settled at different rates. Some careful thought needs to be given to structuring those guarantees. In the InterTAN case, a charge for Canadian creditors was part of that structure. In other cases, balancing charges or some other mechanism may be needed if the estates are going to be settled at different rates, as subrogation and indemnity rights may be inadequate.

In a recent Ontario decision of Justice Morawetz, the Court has set out a number of factors for consideration when it is determining whether to authorize a guarantee in connection with a DIP facility. These factors include the need for additional financing, the availability of financing alternatives (including alternative DIP loan terms), the practicality of a stand-alone solution for Canadian debtors, the likelihood that the guarantee will be called on, potential prejudice to the creditors and potential benefits to stakeholders.7

ENDNOTES

2 United Used Auto & Truck Parts Ltd., Re [1999], 12 C.B.R. (4th) 144 (B.C.S.C. [In Chambers]) at paras. 28–29.
3 Temple City Housing Inc. Re [2007], 42 C.B.R. (5th) 274 (Alta QB).
5 Ibid. at para. 54.
6 Supra note 1, s. 11.2(1) (not yet in force).
7 Indalex Ltd. (Re), [2009] O.J. No. 1541 (Ont. SCJ).

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New Money Priority Ranking:  
A New Tool to Invest and Restructure Underperforming Companies

NICHOLAS THEYS AND STÉPHANIE PAGET

New Money Priority Ranking:  
A New Tool to Invest and Restructure Underperforming Companies

NICHOLAS THEYS
is a partner at SJ Berwin’s Paris office and the president of the French Chapter of the Turnaround Management Association in Paris, France. nicolas.theys@sjberwin.com

STÉPHANIE PAGET
is an associate at SJ Berwin in the Restructuring and Insolvency department in Paris, France.

Article L. 611-11 of the French Commercial Code is dedicated to new money priority ranking. Priority ranking, granted to creditors during a conciliation procedure initiated by French courts against their debtor, is used to finance and restructure underperforming companies.

The French regime of collective proceedings was reformed by the Business Safeguard Act dated July 26, 2005, which entered into force on January 1, 2006. The main object of the act is to save businesses and thus maintain employment. It has reformed the collective procedures.

The legislation modifies the conciliation procedure in order to give the company director a sense of responsibility so that he commences a procedure before the company’s situation is too serious, while respecting the rights of the creditors of the business in difficulty, among other things. This prevention procedure constitutes a unique tool for the company facing difficulties as well as for the creditors benefiting from a reinforced security of their debt.

The conciliation combines contractual and judicial aspects and allows the difficulties faced by a company to be dealt with amicably and confidentially by facilitating the conclusion of an agreement between the company facing difficulties and its most significant creditors. The negotiations relating to the settlement are led by a conciliator appointed by the President of the competent Commercial Court and under the control of the President of the same court. Once the settlement is entered into, the debtor will need to request the President of the Commercial Court to acknowledge or ratify the settlement. The ratification can give rise to a priority ranking that is granted to some creditors subject to certain terms: this is the conciliation priority ranking referred to as “new money” priority ranking.

This security, which is set out in Article L. 611-11 of the French Commercial Code, aims to facilitate the granting of funds or new goods or services to companies facing, at present or in the future, difficulties that are likely to result in a state of cessation of payments (the French insolvency test). Anticipation of a company’s difficulties cannot always be limited to the rescheduling of the pre-existing debt. A cash contribution is often necessary to avoid a collective proceeding at a later stage and to finance sometimes-expensive restructuring measures. It is necessary to persuade and reassure the creditors of these new cash contributions. The new money priority ranking thus offers priority of payment to “deserving creditors” or suppliers to a business undergoing a conciliation procedure if the company is later subject to a collective proceeding.
THE NEW MONEY PRIORITY RANKING
FIELD

Pursuant to Article L. 611-11 of the French Commercial Code, new money priority ranking is granted to persons who have agreed, in a ratified conciliation agreement, to “a new cash contribution in favour of the debtor” and have provided “new goods or services, with a view to insure the continuation of the company’s business activity and sustainability.”

Thus, priority ranking can be enjoyed by any person who has made one of the above cash contributions. The text specifies, however, that the debtor’s shareholders or partners who have underwritten a capital increase cannot benefit from new money priority ranking. Conversely, priority ranking could be granted to shareholders of a company facing difficulties who have extended current account overdrafts. In practice, French commercial courts are uncooperative when granting priority ranking to the shareholders of the business facing difficulties. The aim is that the business should receive third-party support (bankers, suppliers) and not that the shareholder secure its contribution.

Article L. 611-11 of the French Commercial Code also imposes a new cash contribution or the provision of new goods or services by the creditor who is signatory to the conciliation agreement. While the concept of new goods or services is clear, the new cash contribution must be new financing and not refinancing a past debt. As with new goods and services, the new money priority ranking cannot be granted to guarantee payment delay or the cash contribution injected prior to the opening of the conciliation.

The article also states that the financial contribution must have been agreed to in a ratified agreement. This implies that 1) the conciliation agreement refers to the distribution of the amounts paid by new money contributors and refers expressly to the guarantee, 2) the financial contribution has been granted in order to ensure the pursuit of the business activity in the long term and 3) such agreement has been ratified by the President of the Commercial Court. The debtor can choose, once the agreement is entered into, to file a petition to the President of the Commercial Court seeking either to acknowledge or ratify the conciliation agreement.

Only ratification can lead to the establishment of new money priority ranking. It is important to note that the agreement must be ratified by a judgment. An extract of the principal terms and conditions of the conciliation agreement is made public and advertised in the French Official Journal of Civil and Commercial Announcements (BODACC). Thus, the ratification is made public, unlike the acknowledged agreement, which remains confidential. This is a vital point that requires that, when communicating with credit insurers and suppliers, among others, the ratification of the conciliation agreement be viewed as a new start for the business and not of the occurrence of a treasury crisis.

In practice, the choice between acknowledging or ratifying is decided with the creditor when the procedure begins. Indeed, the creditor must know whether it wishes to benefit from new money priority ranking.

The advantage offered by Article L. 611-11 of the French Commercial Code may only be used if a judicial reorganization or a judicial liquidation collective proceeding is opened against the debtor. Conversely, if there is no collective proceeding, the contributor who receives no payment on the due date will be required to have recourse to a civil law collection procedure. This question remains very theoretical given that the debtor who no longer pays its creditors shall very often find itself in a state of cessation of payments.

THE EFFECTIVENESS OF THE NEW MONEY PRIORITY RANKING

Pursuant to Article L. 611-11 of the French Commercial Code, “deserving creditors” are paid for their contribution amount or for the price of the good or service provided by priority ranking before all debts arising before the commencement of the conciliation procedure, according to the priority ranking established under heading II of Article L. 622-17 (applicable to safeguard and to judicial reorganization) and heading III of Article L. 641-13 (applicable to judicial liquidation) of the French Commercial Code. But what exactly is the advantage given to these creditors? Two different cases relating to the absence or the existence of a distribution should be distinguished.

French collective proceedings can be concluded in two ways:

1. The company undergoing safeguard or reorganization can wipe off its pre-filling liabilities. In this case the safeguard or reorganization plan providing...
for the continuation of the undertaking assets are not normally sold and there is no distribution.

2. Presentation of a plan as above is not possible: business assets shall be sold within the scope of a reorganization plan providing for the sale or the liquidation of the undertaking. The sale is coupled with a payment by the purchaser of the business, increased by the amount collected from the client receivables, the overall amount to be used to repay the creditors according to their order of priority. This is defined as distribution.

In the absence of distribution—i.e., if a safeguard or reorganization plan providing for the continuation of the undertaking is adopted—the debt guaranteed by new money priority ranking shall be deemed to be a debt existing prior to the new procedure because of the ban on payment during the observation period and drafting of the plan with the risk of another time spread of up to 10 years (maximum period of time that the Court can impose upon creditors). To this day, Articles L. 611-11 and L. 622-17 of the French Commercial Code indicate that the debts guaranteed by new money priority ranking cannot be paid upon settlement of the conciliation plan, contrary to certain pre-existing debts benefiting from a more favorable treatment.5

Moreover, should the French legislator disagree, would he not have said so in a text as he did previously for certain debts, such as the AGS Employee Insurance Agency debt? The priority ranking thus can only apply in the event of a distribution. However, such rule does not favor new money creditors who see creditors known as subsequent creditors pay, in principle, on the due date and who run the risk of enduring a spread out over 10 years.

In the presence of a distribution, i.e., a reorganization plan providing for a sale or judicial liquidation, debts guaranteed by new money priority ranking are paid before any pre-existing debt, excluding debts benefiting from super-priority of wages and salaries and from priority of legal expenses which are granted a priority ranking under Articles L. 622-17 and L. 641-13 of the French Commercial Code. Priority ranking provided in Article L. 611-11 of the French Commercial Code is a general priority ranking which applies to all the debtor's real and personal property, pursuant to the classification below.

The creditor benefiting from new money priority ranking is therefore the third in line to be paid when the distributions are made following the adoption of a sales plan. The classification in the case of judicial liquidation is nearly identical. Debts guaranteed by real securities, special personal property securities carrying a lien (possessory lien, special liens such as that of the carrier), and a pledge over equipment, tools, and materials are inserted

<table>
<thead>
<tr>
<th>Order of Priority of Debts</th>
<th>Judicial Reorganization—Sales Plan</th>
</tr>
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<tbody>
<tr>
<td><strong>1. Pre-existing debts</strong></td>
<td>1. Super-priority of wages and salaries.</td>
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<td></td>
<td>2. Pre-existing legal expenses.</td>
</tr>
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<td></td>
<td>3. Priority arising from a conciliation agreement.</td>
</tr>
<tr>
<td><strong>2. Subsequent debts</strong></td>
<td>4. Subsequent debts arising out of salaries involving amounts not advanced by the AGS Employee Insurance Agency and to which employees remain entitled.</td>
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<tr>
<td>(lawfully arising after the opening judgment so that the proceedings or the observation period can progress, or in consideration for value received by the debtor for its professional duties during such period)</td>
<td>5. Subsequent legal expenses.</td>
</tr>
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<td></td>
<td>6. Loans granted during the observation period and debts arising out of contracts being performed and whose contracting party agrees to receive differed payment, with the approval of the insolvency judge and subject to publicity requirements.</td>
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<tr>
<td></td>
<td>7. Debts arising out of salaries involving amounts advanced by the AGS Employee Insurance Agency.</td>
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<tr>
<td></td>
<td>8. Other subsequent debts, depending on their order of priority (debts coupled with general preferential payments—Urssaf (French Union recovering social security contributions and family allowances), tax authorities, special securities, other forms of securities, and unsecured debts).</td>
</tr>
<tr>
<td><strong>3. Other pre-existing debts</strong></td>
<td>9. Other pre-existing preferential debts.</td>
</tr>
<tr>
<td></td>
<td>10. Pre-existing unsecured debts.</td>
</tr>
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in this case in the ranking between the debts guaranteed by the conciliation priority and the subsequent debts arising out of salaries.

Therefore, supposing that the property sold is affected by a special security such as a mortgage, the creditor benefiting from new money priority ranking is paid after the creditors ranked before him but before the holder of such special security, it being specified that pursuant to the French principle known as subsidiary, when such special security applies to real property, Article 2376 of the French Civil Code requires that creditors holding general liens be paid first out of the realization of realty assets, and should there be insufficient realty assets, out of personal assets.

The purpose of new money priority ranking thereby appears clearly within the limit of the distributable amount.

ENDNOTES

1Articles L. 611-1 to L. 611-15 of the French Commercial Code.

2This concerns a legal security interest conferring general priority ranking to the creditor as regards the assets of its debtor, a priority ranking within the meaning set forth in Article 2324 of the French Civil Code: “a right given by the quality of the debt claim to a creditor to be preferred above other creditors, even mortgages.”

3All new goods and service providers are concerned.


5See Article L. 626-20 of the French Commercial Code which only grants such advantage to debts guaranteed by the priority of wages and salaries not advanced by the AGS Employee insurance Agency and to smaller debts.

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The Journal of Private Equity
Great Lakes Group
54722 Little Flower Trail
Mishawaka, IN 46545
Phone: 773-702-1045
jimschrager@compuserve.com