1

Introduction

In order to survive, a company in financial distress must approach its business and capital structure differently than a financially sound company. A company in financial distress may, for example, need to preserve cash by stretching accounts payable, raise cash by selling assets, or arrange for emergency liquidity from existing or new lenders. The response of a company to its deteriorating financial condition will almost certainly affect, perhaps in material ways, a company's key constituents.

From the distressed company's perspective, early detection, immediate strategic planning and timely execution on a responsive course of action will be critical to help the company avoid a substantial deterioration of its enterprise value. There is no bright-line test that announces that a company is in, or is approaching, financial distress. A company's board and management must, of course, recognize the warning signs of distress as early as possible.

From the perspective of a distressed company's key constituents—such as a vendor or customer—recognizing and planning for a counterparty's financial distress may be critical

to the incurrence of losses from goods sold or the certainty of receiving an undisrupted flow of goods or raw materials necessary to keep the supply chain running smoothly. And, of course, for a lender, the early recognition of financial trouble may enable the lender to manage its exposure to maximize its ultimate recovery.

This chapter discusses some of the signals of financial distress and the implications for the distressed company and its key constituents, and introduces some of the strategies for each of the critical players in the dynamic situation of a company's slide into financial distress.

Financial Distress Generally..... 1–2
Effect on Fiduciary Duties 1–12
Disclosure 1–15

Financial Distress Generally

Q 1.1 When is a company in "financial distress"?

"Financial distress" is a financial condition that presents an appreciable, realistic risk that a company, in the relatively near term, will suffer a liquidity crisis that would adversely affect the company's viability as a going concern. A variety of events, sudden and unexpected, or long-simmering and anticipated, can trigger financial distress. Regardless of the cause, all financial distress shares one irrefutable and debilitating characteristic: lack of adequate liquidity to sustain the viability of a business. The one thing that the business failures as diverse as Caesars Entertainment, American Airlines and Macy's Department Stores, for example, all had in common, is a liquidity crisis. These companies had little choice but to recapitalize through a Chapter 11 bankruptcy, which caused creditors to suffer losses, and had impacts on employees, suppliers and customers in the process.

EXAMPLE: A tainted product that must be recalled, a serious marketing blunder, product obsolescence and formidable competition are all examples of events that could lead directly to financial distress.

NOTE: Even the most successful business enterprise will suffer failure and setback from time to time. Ford Motor Company launched one of the greatest product failures of all time in the Edsel, and Coca-Cola dented its seemingly impervious brand with New Coke. Johnson & Johnson was confronted with consumer panic as a result of poisoned Tylenol, and British Petroleum will wrestle with the Gulf of Mexico disaster for many years to come. But none of these companies was considered to be in financial distress because none faced an appreciable, realistic risk of a liquidity crisis that would threaten its viability.

Q 1.1.1 What are some of the warning signs of impending financial distress?

Some warning signs of impending financial distress are clear clarion calls of danger, while others are more opaque and require further analysis. Recalling the definition of financial distress and its focus on liquidity, data that bears on liquidity will be of particular importance in assessing the risk of impending financial distress. A company's principal sources of liquidity are its cash flow and its financing activity.

EXAMPLE: The failure of a company to make a principal or interest payment on its debt is an obvious warning sign of financial distress, albeit one that may signal that a company already is in financial distress rather than heading in that direction.

TIP: A default under a loan agreement's or indenture's financial covenants could very well signal impending financial distress. On the other hand, a financial covenant default may be the result of some issue that does not carry important signs of financial decay or be a "false positive" as a sign of financial distress. A financial covenant breach clearly requires further analysis and the consideration of other data points in order to ascertain whether it should be viewed as a warning of impending financial distress.

Q 1.1.2 How is cash flow an important warning sign?

One key factor to monitor when assessing a company's liquidity is cash flow, which is why management and the board will be particularly sensitive to the trend in a company's cash flow. Management will use reporting tools such as sales forecasts, cash-flow projections and budgets for given periods of time, compared with actual results, to analyze financial health and detect signs that may be of concern. Those reports will be dissembled and analyzed by specific categories of revenue and expense—often by product or service type, region, expense category, customer and the like. Management will consider factors such as seasonality in sales, unusual or nonrecurring events, and timing of major or capital expenditures in properly analyzing the data and reaching conclusions as to a company's financial condition. Management and the company's board should be in a position to determine whether a company's cash flow portends a potential squeeze for which available liquidity will be inadequate. If the reporting is of high quality, and management heeds the warning embedded in the data, there may be a long enough runway of time for the company to take corrective action and avoid a crisis.

Q 1.1.3 How is financing activity another important warning sign?

The other key to assessing a company's liquidity is monitoring its financing activity. Financing activity comes in a wide variety of forms, such as asset-based loans and revolving credit agreements, long-term bonds, accounts receivable factoring, letter-of-credit facilities and

commercial paper. A company with debt or financing instruments will need to manage its cash flow in a way that enables the company to service its debt and pay debt as principal installments come due and repay or refinance debt at maturity.

Q 1.1.4 How can availability of a company's revolving credit facility be affected by its financial distress?

A company that depends on a revolving credit facility as a critical source of liquidity must be certain that funds under the revolver will be available when and as the company needs to access funds. Typically, revolving credit will be available up to a limit and subject to the satisfaction of conditions precedent to borrowing. If a company has "sized" its revolver too tightly—not having a commitment that provides a cushion for unanticipated events—or is faced with an unexpected need for cash because of material changes in revenue, it could find itself in the throes of a liquidity crisis and at the mercy of the revolving lenders' willingness to increase their commitment.

Even if a revolving commitment is adequate in amount, revolving credit lenders may legally refuse to advance funds to a borrower if the conditions precedent to an advance are not satisfied. The nature and extent of conditions precedent to a revolving credit agreement vary, but most require at a minimum that at the time of borrowing there be no event of default existing and that the representations and warranties contained in the agreement be true and correct. Thus, management needs to appreciate when negotiating and entering into a revolving credit facility that the covenants, representations and warranties will all have a continuing effect and be a critical factor in the company being entitled to access liquidity in the future. On an ongoing basis, management must monitor the company's financial affairs carefully relative to revolver covenants so that it can predict when waivers or amendments may be needed in advance of a borrowing need in order to forestall a liquidity crisis brought about by being denied access to borrowings under the facility.

Q 1.1.5 Who is in the best position to recognize signs of impending financial distress?

Management of a company and, through the management reporting process, the board of directors, will have more data regarding, and

greater visibility into, a company's near-term financial health than any other constituent. Management and the board must be sensitive to those indicators that should be viewed as warning signs of impending financial distress.

For non-insider constituents of a company, it may be much more difficult to ascertain impending financial distress because those constituents will not have access to the same data as does management and the board. Companies with public reporting requirements under the securities laws are required to disclose certain information about their business, including information regarding liquidity and management's discussion and analysis of the business. The degree to which disclosure can give the reader warning signs of trouble may well be a function of the quality and candor of the disclosure. Public disclosure should be read carefully and critically for signs of liquidity issues ahead. Any unusual or out of the ordinary cash management activities may be a warning sign and should be analyzed further.

EXAMPLE: A company that is taking longer to pay its payables or is delaying previously announced initiatives or projects may be a signal that the company is seeking to preserve cash and may be facing a liquidity crisis.

Q 1.1.6 What are some of the consequences of triggering a default under a loan agreement, bond indenture or material contract?

The occurrence and continuance of an event of default under a loan agreement, bond indenture or other material contract can have very serious financial and liquidity implications for the company. The most obvious, perhaps, is the counterparty's right to enforce remedies against the company. Remedies under a loan agreement could include the acceleration of the maturity of a loan, the termination of any commitment to make any further loans and the foreclosure on collateral under a secured facility, any of which could place the company in

financial distress. Under a bond indenture, a default could trigger the right of the bondholders to accelerate. In the case of another material contract, remedies could include the termination of the contract and a lawsuit seeking damages. Depending on the contract, its termination may have a material adverse effect on the company leading to financial distress.

Pursuant to the terms of a loan agreement, a lender typically is not required to honor a loan commitment if an event of default has occurred and is continuing at the time a borrowing is requested. In addition, a normal condition to borrowing is that the borrower not be in "default" under the loan agreement. A "default"—or latent event of default—is an event which, with the passage of time or giving of notice, or both, would become an event of default. Thus, under the terms of a loan agreement where a default or event of default has occurred and is continuing, absent a waiver by the lenders, the company will not have access to committed financing, possibly creating a liquidity crisis.

Q 1.1.7 What is a "cross-default"?

Even where a borrower is current on its debt service obligations under a loan agreement and is otherwise in compliance with all of its covenants and other obligations under a loan agreement, a default under a material contract could, by virtue of a "cross-default" clause, trigger an event of default under the loan agreement, permitting the lender to exercise its remedies. A cross-default clause operates as a catch-all early warning signal for lenders pursuant to which events that may adversely affect the company and are not otherwise immediately captured under defaults or covenants in a loan agreement trigger an immediate event of default.

A company naturally will want to narrow the application of a cross-default clause to only the most material events that would almost certainly lead to a significantly adverse outcome. Lenders, on the other hand, will often seek a broader cross-default clause with the intent of capturing any event that may alter for the worse the risk and credit profile that formed the basis for making the loan originally.

Q 1.1.8 What is a financial covenant?

Financial covenants in loan agreements are requirements related to the company's financial condition, generally expressed by reference to a given time period. A "maintenance" covenant requires a borrower to maintain a particular financial covenant throughout a stated period. In contrast, an "incurrence" covenant requires a borrower to satisfy a financial covenant requirement at a specific point in time when money is borrowed.

EXAMPLE: A maintenance covenant could require a borrower to maintain at all times during each of its fiscal quarters a ratio of indebtedness to earnings before interest, taxes, depreciation and amortization (EBITDA) for a rolling twelve-month period of not less than x to y.

EXAMPLE: An incurrence covenant could require a borrower to have EBITDA for its first fiscal quarter of not less than $x in order to make a borrowing on a revolver.

Q 1.1.9 When is a financial covenant for a specific reporting period breached?

Reporting of actual financial information within a company—or a "closing of the books"—will normally occur after financial events themselves occur. Thus, it may be several weeks after a given reporting period occurs before actual information against which reporting covenants are tested is finally prepared and a covenant is breached.

NOTE: Management may have strong indications, or know to a virtual certainty based on flash reporting or other periodic updates, that the company will not be in compliance with one or more of its financial covenants either at some point in time during the applicable period (in the case of a maintenance covenant) or at the end of the applicable period (in the case of an incurrence covenant). Nevertheless, the financial covenant testing frequently occurs only after definitive actual financial reports are generated for the applicable period covered by the financial covenant rather than at an earlier point when management may have had knowledge of the likelihood of the financial covenant breach.

Q 1.1.10 Is it typical that lenders or bondholders are entitled to exercise remedies individually?

In a syndicated loan agreement—one where multiple lenders that commit individually to provide loans to a borrower are party to one common loan agreement—and in an issue of bonds or other debt instruments pursuant to an indenture, generally the right to exercise certain remedies is not available to individual lenders or bondholders. Rather, an agent or trustee may exercise remedies subject to the consent of creditors holding a stated minimum percentage of indebtedness. The right to accelerate all or any portion of the indebtedness, for example, is frequently subject to direction given to the agent in a typical bank loan of lenders holding at least 51%, or sometimes 66 2/3%, of all debt outstanding under a specific loan facility. (Often, the requisite aggregate amount to require the trustee to accelerate indebtedness under an indenture is at least 25%.) Similarly, the taking of legal action to foreclose on collateral or the waiving of most defaults typically is subject to the collective direction of a stated percentage of the debt governed by a loan agreement or indenture. Payment defaults—the failure to pay principal or interest when due—as to any particular lender or bondholder, however, typically can only be waived by such lender or bondholder. In addition, a lender typically will retain the individual right to collect payment of principal or interest when due.

Q 1.2 Why is it critical for a company to acknowledge that it is in financial distress?

Only when a company recognizes and acknowledges financial distress can it then devote the appropriate management and board time, energy and focus, and marshal the resources necessary to develop a strategy to address the root causes of the financial condition and reverse the situation. Almost any strategy designed to arrest and reverse a condition of financial distress will require lead time and planning to implement effectively. Thus, the earlier the company acknowledges distress, the sooner it can begin contingency planning in an effort to mitigate as much as possible the deterioration of enterprise value.

Q 1.3 Why is it important for vendors and other creditors to recognize financial distress?

Vendors and other creditors of a company have a stake in the financial health of the company. The cash flow that vendors and other creditors expect from a company may be critical to their own operations and financial health and ability to meet their own financial obligations. Accordingly, vendors and other creditors need to recognize financial distress in order to be able to manage their exposure and implement contingency plans in order to optimize the ultimate recovery of credit extended to the financially distressed company.

Q 1.4 Why is a "going concern" qualification important?

A company generally is required to have its auditors conduct an annual audit of its financial statements and to disclose the results of the audit to its debtholders pursuant to a loan agreement or indenture or to disclose the results publicly pursuant to applicable securities laws. At the conclusion of an audit, the audit firm will issue an audit opinion letter. In giving its audit opinion, an auditor is required to consider whether the company will be viable for at least twelve months after the date of the audit opinion. The auditor is directed by auditing rules to take into account factors such as negative recurring operating losses, working capital deficiencies, loan defaults and the prospects

for necessary financing. A "clean" or unqualified audit letter essentially is an expression of the auditor's view that the company's financial statements present a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements, without any significant reservations. If there is substantial doubt about a company's ability to remain viable as a going concern, however, the auditor is required to disclose that doubt in its opinion, known as a "going concern" qualification.

A going concern qualification is a signal that a company may be in, or heading toward, financial distress. Receiving a qualified audit opinion typically triggers an event of default under loan agreements and indentures, permitting debtholders to terminate commitments and to exercise remedies. To the extent the qualified opinion is publicly disclosed pursuant to applicable securities law requirements, or otherwise becomes known generally in the marketplace, vendors may shorten the terms of the trade credit they are willing to extend or put the company on a COD (cash on delivery) basis. If trade credit tightens materially, the company may find itself in a liquidity crisis if it is unable to generate sufficient cash flow from operations or borrowings under credit lines to pay accounts payable that are coming due faster as the company's credit cycle shortens.

Customers may also have serious concerns about the receipt by a supplier of a qualified opinion. If, for example, a company supplies technical components with customized specifications or sophisticated, highly engineered products, where production platforms may take significant time, customers may determine it is prudent to consider second sourcing or qualifying alternative suppliers to manage against the risk that the going concern opinion is a harbinger of financial distress and a threat to the customer's supply chain.

Q 1.5 Can a solvent company be in financial distress?

Solvency is generally considered to be a financial condition in which (a) the fair saleable value of a company's assets exceeds all of its liabilities, (b) a company is generally paying its debts as they come due, and (c) a company has sufficient capital to conduct the business in which it is engaged. The definition focuses on a company's balance

sheet, a company's present ability to pay obligations and on a company's capital base. What the definition does not consider directly is the company's prospects in the near term.

A company can meet the balance sheet, present payment and capital tests of the definition of solvency but still be facing a near-term liquidity crisis. For instance, a company's asset value may exceed its liabilities, but it may have a significant amount of debt maturing in the next several months. The company may be unable to arrange for refinancing because of adverse market conditions or the company's business prospects or otherwise. The company, though solvent, will be in financial distress if it cannot arrange refinancing. The impacts of that financial distress can be exacerbated if suppliers or customers then begin to alter their behavior to address the company's distress.

EXAMPLE: A contributing factor to the Toys "R" Us Chapter 11 filing was a significant interruption in trade support just prior to the critical holiday selling season, when suppliers became concerned about Toys "R" Us's financial health.

Moreover, as discussed in more detail in chapter 5, under the Bankruptcy Code there is not a requirement that a company be "insolvent" in order to file a bankruptcy petition.

Effect on Fiduciary Duties

Q 1.6 Do the fiduciary duties of directors and officers change when a company is in financial distress?

For purposes of determining to whom fiduciary duties are owed, the relevant financial condition is not financial distress, as such, but solvency.

In a solvent company, fiduciary duties are owed exclusively to equity holders. The rights and entitlements of creditors, and the duties owed by a board of directors and officers of a solvent company to creditors, are only contractual (although creditors may be granted standing to assert claims for a breach of fiduciary duties to the corporation). When a company is insolvent, however, a board of directors and officers owe fiduciary duties to creditors as well as to equity holders. When a company is in the "zone of insolvency," directors' and officers' duties still are owed to equity holders and not to creditors, but directors and officers must be aware of the possibility that there could be an impending shift in their duties.

Q 1.6.1 What should directors and officers do to protect themselves when the company begins to experience financial distress?

Directors and officers of a company owe fiduciary duties to stockholders and, if the company is insolvent, owe fiduciary duties to creditors as well. One of the principal fiduciary duties is the duty of care. The duty of care requires that a director or officer be fully informed of the relevant facts and circumstances when making decisions and taking action.

In the ordinary course, the duty of care may be discharged satisfactorily by the receipt of periodic financial and operating reports, and regular management and board meetings. When signs of financial distress begin to appear, however, directors and officers need to consider whether they are equipped to make the critical judgments that they will be faced with in the distressed environment. It may be the case that senior management and directors do not have any experience with financial distress, in which case, care will dictate that the company hire financial professionals with such experience.

TIP: In discharging the duty of care in the context of financial distress, it may be prudent to consider engaging experienced legal and financial experts to advise senior management and directors. Directors and officers generally are entitled to rely on the advice and recommendations of experts in discharging their duty of care. Hiring restructuring or bankruptcy advisors does not generally require specific public disclosure.

In a worst-case scenario, financial distress can lead to insolvency, bankruptcy and litigation with creditors. If litigation were to occur as a result of a company's financial distress, it is very possible that litigants would conduct discovery of directors and officers, including examining the decision-making process and response to the company's deteriorating financial condition. Plaintiffs likely would seek board minutes, including copies of presentations made to the board, and notes that directors may have taken during board meetings. In addition, plaintiffs likely would seek deposition testimony from officers and directors who attended board meetings held during the time the company was addressing its financial distress.

TIP: It may be important for directors to consider, and seek advice of counsel, with respect to practices regarding the written record of board meetings that, when reviewed in retrospect, will accurately reflect the board's deliberations and actions and provide support for the board's discharge of its duty of care.

Disclosure

Q 1.7 Is a company required to disclose publicly that it is in financial distress?

A public reporting company is not expressly required to disclose publicly that it is in financial distress. A reporting company is, however, required to disclose information regarding its financial condition, liquidity, business trends, and other material events that could lead a reader to reach the conclusion that the company is in financial distress.

Under applicable securities laws, a public reporting company is required to file quarterly, for its first three fiscal quarters in each fiscal year, financial statements that are required to include an income statement, balance sheet and statement of cash flow. In addition, the filing must contain management's discussion and analysis of the company's business. These filings are made on Form 10-Q and filed with the Securities and Exchange Commission (SEC).

A reporting company is also required to file an annual report and audited financial statements after its fourth fiscal quarter. The annual filing requirements are considerably more extensive than the quarterly filings and are filed with the SEC on Form 10-K.

In addition to periodic reporting on Forms 10-Q and Form 10-K, a publicly reporting company is required to disclose with the SEC on Form 8-K any material event impacting the company.

EXAMPLE: Material events that may require disclosure on a Form 8-K include events of default under material contracts or loan agreements, as well as waivers under or amendments of loan agreements and forbearance or similar agreements entered into with lenders.

A company that is not a public reporting company typically will not have an obligation to disclose its financial condition on a regular basis. As a result, it generally is more difficult to detect early signs of financial distress for a "private" company than it is a public reporting company.