



# **Understanding Insolvency:** *the Lender's and Leader's Perspective*

**BY TERRY BARTZ**





In a corporate environment, the leader and often the entire management team are responsible for a company slipping into insolvency. They failed in their fiduciary responsibility to see over the horizon and plan accordingly, regardless of the state of the economy. However, before dispatching the entire group, it is important for asset-based lenders to evaluate and consider retaining team members because there are likely to be some whose work can add value to the company as it moves forward.



The blame game is a hard, cold fact of life. Whether the subject is sports, politics or business, the finger-pointing begins when events seem to be out of control. And the pointing starts at the top. Even if an unpredictable event such as a natural disaster has drastically reduced, if not eliminated, profits, everyone holds the chief executive officer responsible. An axiom among military officers no doubt applies to the business world: “The commanding officer is responsible for all the troops do — and all they fail to do.” That’s especially true for companies that are insolvent or are on the verge of insolvency.

But should the leader and management team shoulder the blame for a company careening into insolvency, even when the economy has shown minimal growth at best and stagnancy at worst? The answer is yes in an overwhelming majority of cases because the CEO and the executive management team have failed in their primary mission — to see over the horizon and plan accordingly.

As a result, when an infusion of liquidity from asset-based lenders (ABLs) may be a workable option for an enterprise, lenders often lack confidence in the enterprise’s leadership team. This is generally the kiss of death. “One of the tests of leadership is the ability to recognize a problem before it becomes an emergency,” wrote the late business writer Arnold Glasow.

### **Contributing to Insolvency**

Leaders are paid to think big and plan strategically. ABLs and other constituents need assurance that they are getting realistic and accurate short-term and long-term projections on which to base their decisions. All of this may seem like common sense, but common sense doesn’t always exist.

Further, an executive’s past achievements do not guarantee future success when restructuring is required. The fact may well be that the senior leader is incapable of handling

an insolvency crisis. The reasons are many. First, the executive may have failed to comprehend the current business environment accurately — a misdiagnosis with potentially fatal results. Second, a top executive may be unable to function in the strategic realm. The real focus is on the tactical front, especially if the leader has always been “a doer” — someone who often analyzes specific problems and resolves them. With insolvency issues, the problems are far more complex, and they require a different mindset.

Another CEO error is failure to evaluate the performance of other members of the leadership team properly. In some cases, these individuals may have served the CEO in other organizations. As a result, these executives may take their roles for granted because they proved themselves elsewhere. The reality is that the CEO should have paid more attention to the executives’ current performance and their possible role in the company’s distressed situation.

Management style is another contributing factor to insolvency. There is no shortage of case studies of failures attributed to a CEO’s management style of rule by fiat — an arbitrary order issued from the top that the rest of the management team is expected to rubber-stamp without questions or comments. A better environment is one in which subordinates are not afraid to challenge ideas and policies, with the understanding that their role is to implement once the final decision is made. Yet, many high-ranking subordinates do not dare voice objections for fear of reprisals when a CEO tends to view such responses as insubordinate.

At the opposite end of the spectrum is the completely hands-off CEO who violates a cardinal rule of leadership — delegating responsibility along with authority. Although members of the upper management team certainly have responsibilities, the one who is ultimately accountable sits at the top of the pyramid. As successful CEOs are

quick to point out, shared responsibility means no responsibility. An executive with a history of deferring is not likely to win support of ABLs when the money crunch arises.

This is not to suggest that the blame for a company’s distressed situation lies solely with the top executive. There are a number of external causes that can place a business in crisis, from natural disasters to a slow- or no-growth economy, as is currently the case. Such challenges require resolute responses. They can be the ultimate test of management skill, yet a common response is merely to pull back and circle the wagons.

Executives may base this approach on the uncertainty of the economy, coupled with either the lack of adequate information for long-range projections or workable competitive intelligence. There never seems to be enough information, they argue, so they have to defer strategic decisions. No one seriously considers taking bold steps that might save a company from insolvency.

The term that best describes this management style is “analysis paralysis” — the inability to act when actions are most desperately needed. Analysis paralysis often occurs when management waits too long to react, if it acts at all, when data and projections show profitability trending the wrong way. Another example is a leader’s unwillingness to make personnel changes or perhaps close down some divisions, despite data confirming their drain on liquidity and profits.

The common denominator for all of these situations is the ultimate abdication of leadership: the failure to act. It’s one thing to be prudent; it’s another to be inert. ABLs have to recognize the difference.

### **The ABL Discovery Phase**

Experienced ABLs should be able to identify the signs of failing leadership quickly. Some of the indicators are quite predictable. One is a chief executive who is unable to provide

**"These team members have actually quit in place, offering little in the way of suggested solutions because they believe the top executives won't listen. They have, in effect, become automatons, going through the motions and carrying out dictates without commitment. It is an absolute worst-case scenario."**

a satisfactory, detailed explanation for the company's distress and a realistic, workable plan for recovery. In this environment, however, other members of the management team may have no reticence about identifying what is causing the bleeding. The odds are that they will be reluctant to point the finger at the CEO for obvious reasons, but that does not mean there aren't tell-tale signs. One of the most obvious is a rash of leadership resignations when the company is on the verge of distress or is already gasping for liquidity. Another warning is the team's lack of enthusiasm in carrying out executive orders. When their hearts aren't in it, they are subtly showing their loss of faith in top management.

These team members have actually "quit in place," offering little in the way of suggested solutions because they believe the top executives won't listen. They have, in effect, become automatons, going through the motions and carrying out dictates without commitment. It is an absolute worst-case scenario. Things may appear normal and may even escape lender scrutiny, but quitting in place is likely to be a major factor should the enterprise fail.

The uppermost question in the minds of lenders, particularly those whose asset-based lending is probably the company's last resort, is whether the current management team is capable of successfully leading the

business through restructuring. For the answer, start by separating senior leaders from managers to determine who, if anyone, has been an effective manager and problem-solver. The person at the top may be ineffective and have to be replaced, but the same fate may not be necessary for the entire team.

So how can ABLs judge whether a team is competent enough to pull through a restructuring, especially if they have doubts about the CEO? One way is to secure analytical assessments of job performance from independent consultants. A third-party review may conclude that the top executive has neither the vision nor plan likely to produce turnaround success, but it may also find that the supporting management team is competent enough to implement a turnaround strategy.

One example comes from a Midwest company composed of analytical chemistry laboratories. In this case, the foundering firm became over-leveraged through some ill-advised expansions, including the acquisition of one company with a severely flawed business model. The CEO resigned at the insistence of the firm's secured lenders. The lenders discovered through an independent analysis that the management team was well worth keeping. During a federal court receivership, the failing companies were turned around and then sold. The newly empowered team produced exceptional results in under a year:

revenues increased by 25% and profitability increased an amazing 40%. The lender was able to move from a potential 75% loss to a loan that was paid in full.

"It's as if the shackles were taken off us and our employees and customers were energized," said one of the remaining senior managers. Enterprise performance improved rapidly and markedly, resulting in one of those rare instances during insolvencies in which managers and key members of the staff received performance bonuses.

As this example shows, there are times when a leadership team can fix problems to the satisfaction of lenders, especially when analysis has shown that members' competencies, capabilities and even creativity may go a long way toward a less painful restructuring. Even if the company retains its senior leader for institutional continuity, the ABLs may find that restructuring is best served when they effectively marginalize a retained executive, enabling the management team to perform at its best. The lender can place the CEO in a nonoperative position that will not affect the team's performance. This is, admittedly, an awkward scenario that should be avoided. It could, however, be an acceptable alternative for lenders if the team below the executive adds value to a company in desperate need of it. In most cases, though, the preferred solution is removal of the executive.

Sometimes, constituents tend to focus on tactical issues such as real-time and long-term status of accounts receivable and whether revenue receipt is unacceptably slow. It is important to understand that any difficulties in the financials are parts of a bigger picture. That means understanding the circumstances and policies under which senior leaders and the management team allowed the financial problems to occur.

One option that can help keep upper management focused on strategy is having a third party review A/Rs and customer lists. Management may have differing opinions over the value of this option, but the team's acceptance is vital if such efforts are to succeed. The same holds true with management's views on covenants, particularly if the third party finds that they impede the revenue-generation goals necessary for a successful turnaround.

At the core, however, is retaining institutional competence by keeping an effective team in place, but there are some caveats. An interim executive, assuming one is in place, will no doubt want to decide if each managerial subordinate is worth keeping and may also request third-party assistance in making that decision. Another caveat is that regardless of competence, lenders and third parties cannot allow the management team to hold them hostage. The only time the lender should marginalize a leadership team is if restructuring fails, no further options are available and the company has no choice but to enter liquidation. That is the worst-case scenario — one that every secured lender wants to avoid.

### **Post-Insolvency Challenges**

When a company emerges from restructuring and projects eventual profitability, there are still a number of considerations that require agreement from leaders and ABLs. The first is the necessity of the leaders to meet the ABL's demands for consistency and credibility. No doubt, the same holds true for other creditors, customers

and suppliers that want to see clear indicators of an emergence from insolvency. At this stage, it is incumbent upon leaders to set achievable goals and to establish buy-in with lenders. Communication with lenders and all constituents should be mandatory so that all parties know that the company is achieving goals and making progress.

Also, it is essential for lenders to insist that leaders provide the short-term prognosis for accounts receivable and inventory in order to show signs that a turnaround is working. Lenders cannot allow the company to extend terms for accounts receivable that jeopardize liquidity. Similarly, the company needs to exercise greater control of inventory to keep costs within acceptable limits.

The emphasis has to be on short-term goals. Avoid long-term promises, especially during such a difficult and transitory phase. The company's goal is to regain momentum as a viable and competitive entity. One need only look at General Motors, which, although spared by a federal bailout, had to reestablish itself against ferocious competition in the worst of economic times. After replacing its CEO and eliminating two of its best-known brands (Pontiac and Saturn), GM reemerged as the manufacturer of some of the top-selling domestic cars in 2011. The company is once again competitive and profitable. Few were willing to predict these results.

A well-known adage pertaining to leadership at sea is applicable here: anyone can handle the helm when the seas are calm. Although there should be little question that failed leadership deserves most of the blame when a company is in the zone of insolvency, that does not necessarily mean that lenders should dispatch all of the leaders responsible for the distressed situation. Lenders may wish to consider installing an interim leader who can integrate seamlessly into the business and determine who is worth retaining. It is especially important for the

interim leader to keep the antennae tuned to sources of employee discontent, lack of communication and improper resource management, all of which are topics of interest to an ABL that wants to make sure the credit line is having its intended impact.

Restructuring is always a sensitive issue, particularly when it involves major changes in leadership. That is why the new leader, who makes communication a linchpin of turnaround strategy, stands a better chance of making it through restructuring than the predecessors whose decision-making or lack of it led to insolvency. Lenders, much like institutional investors, abhor uncertainty. That's why open and frank discussions about turnaround progress need to be ongoing. Neither leaders nor lenders should expect anything less. **TSL**

Terry Bartz is managing director of MorrisAnderson, a national consultancy whose service offerings include performance improvement, financial advisory, interim management, turnarounds, workouts, litigation support, insolvency services and wind-downs.