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How can boards help their companies navigate distress—before it's too late?

Any company could face financial distress at some point. In a worst-case scenario, those pressures could be serious enough to put it out of business.

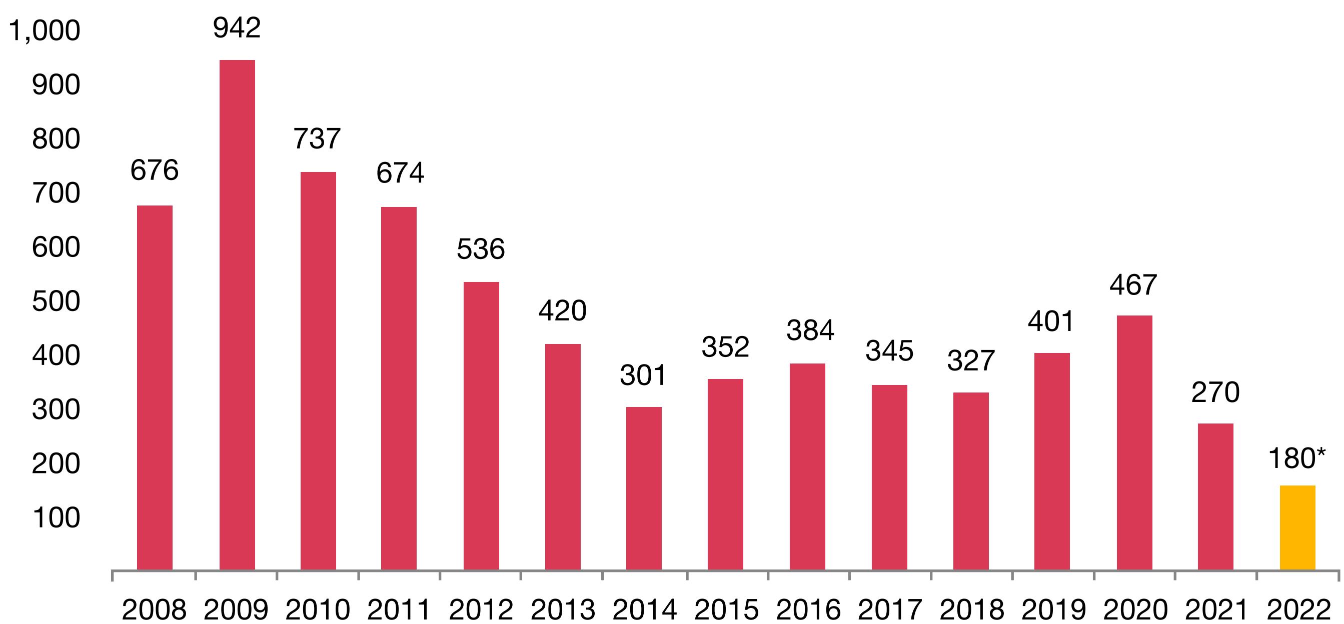
Boards should be prepared to deal with rapidly deteriorating conditions that could push a company into a restructuring. Directors who know the warning signs can help their companies head off bankruptcy—or at least be in a better position to emerge successfully.

Businesses, industries and the economy as a whole are cyclical in nature. Any company can become susceptible to financial distress. A lengthy economic downturn can affect consumer cyclicals such as automotive, housing, entertainment and retail. New technology may fundamentally change the relationship between certain businesses and their customers. Companies may also face unique existential threats brought on by regulatory changes, senior management turnover or increased competitive pressures.

Different circumstances can send industries into downturns. For example, the global COVID-19 pandemic hit airlines and other travel-related businesses hard while bolstering online retail. But the travel industry began to recover as COVID-19 concerns receded. At the same time, some retailers saw online channels slump as customers returned to in-person shopping.

Directors should recognize that every company could at some point face severe financial distress. Accordingly, directors and management must be prepared to deal with rapidly changing circumstances that could cause such distress. One of the ways companies may try to alleviate financial distress is through a financial or operational restructuring.

Chapter 11 filings by year



Source: The Deal, Reorg, Debtwire

*Note: 2022 contains Chapter 11 filing data through September

Directors will likely know if a company or a sector is already in distress. But what can boards do if an individual company—or the entire industry—is just beginning to experience signs of distress?

Spotting the signs can be difficult for directors, especially since they aren't managing the day-to-day operations at the company. It's often hard to know if a certain challenge is a blip on the radar or a sign of more trouble ahead. And unless there are obvious fires to put out, executives may not want to admit to their board—or to themselves—that their company is struggling.

Various factors could create a distressed situation. Accept the possibility that your company may need to have conversations about its financial and operational resiliency. While management handles the day-to-day, boards should be looking ahead to ensure the company is adequately addressing risks and developing a plan to mitigate.

Knowing the early warning signs

It's crucial to identify potential signs of distress as early as possible. Doing so helps management and the board preserve options. Think of it like your personal health. Early diagnosis typically gives doctors a broader array of potential treatments but if you ignore symptoms until the condition becomes worse, your treatment options may be limited and possibly more drastic.

Early warning signs are not always obvious. It's also challenging to diagnose problems that could mushroom into major issues. But early identification of issues can help a company refocus its strategy and give it a better chance to stabilize operations and preserve value.

Realistically, how can boards diagnose symptoms of trouble—especially when directors aren't at the company every day? Start by looking critically at the performance information you get from management at every meeting. Identify the way the information is being presented so you can determine if it is consistent and you are able to see trends; if not, ask why not. Insist that the information you receive from management can address the company's cash and liquidity positions. Determine if it's similar to what you're hearing about the state of the industry and the company from other sources. Press for more detail or explanation if you see one or more of these warning signs.

Perhaps most importantly, directors should be willing to accept that distress could be on the horizon, even if management is more optimistic on the company's outlook. It's just good business to get out in front of issues. It helps preserve options and can increase the company's ability to negotiate from a position of strength.

Common warning signs of potential distress in a company can be:

- Activists or analysts repeatedly identifying weak points related to the company's financial position, strategic plan or business model
- New regulations that affect multiple parts of company strategy and disrupt the business model
- Declining profits or recurring losses
- Not recognizing or responding to technological innovation that fundamentally changes customer behavior and demand for products/services
- A particularly serious restatement or ongoing investigation that is costly and damages trust in the company—and may limit its ability to raise additional capital until the matter is resolved
- New market entrants that disrupt current business models
- Steep decline in stock price or recent debt ratings downgrade
- High leverage
- Sudden departure of a key executive or multiple executives leaving within a short period of time
- Increasing working capital constraints or ineffective cash flow forecasting
- Repeated deferment of key capital expenditures needed to operate or grow the business

If not addressed early, what may seem like an isolated problem could be the tipping point that forces the company into insolvency.

Assessing the situation and developing a plan

If you've identified some warning signs, you'll want the company to be able to increase the available financial and operational options. Directors should encourage management to do a holistic review of the business. This includes evaluating recent financial performance, the business plan and financial forecasts, management team capabilities, short- and medium-term liquidity needs and the capacity to access capital markets. Once management has analyzed the situation, it's much better positioned to help assess options and recommend a plan.

Directors should review this plan with a critical eye as management may have a rosier lens that may not reflect reality. Directors might want to request analysis to help them prepare for best, worst and most likely scenarios.

If the company is faced with potential distress, the board may want to create a special committee of directors who can focus additional time and attention on the issues. Boards (or the special committee) will want to consider retaining their own advisors. These advisors would report to the board but work closely with senior management on a turnaround plan. That plan should focus on key financial and operational concerns. If management also hires consultants, those consultants should be available to present to the board.

Elements of a turnaround plan, and key questions for each

Issue	Board questions for management
Liquidity and working capital Insufficient cash monitoring and poor working capital management can introduce unnecessary risk to an otherwise stable business. Companies that end up in distress often point to an over-leveraged balance sheet and weak controls around the billings and collections process. This can lead to stretching payables to meet short-term liquidity requirements.	What quick wins can we get in working capital improvement or other cash generation actions? What would it take to execute a realistic cost reduction plan? What does a working capital benchmarking exercise—that compares the company's performance against peers—tell us about potential areas for improvement?
Access to capital Companies should assess their overall capital structure to ensure it is appropriate for their current level of performance and able to withstand the impact of external risk factors. Usually, the more time you can buy from your creditors, the better off you can be.	What debt covenants are we close to breaching and do we have debt maturing in the next 12 to 18 months? Who is monitoring the situation, and what are we doing about it? Which of our financial covenants, debt repayment schedules and other terms are open to negotiation? How could we negotiate new amendments and waivers to help provide more stability? Which creditors could we approach now to restructure existing financing facilities, instead of waiting for a crisis?

Operational efficiency and organizational structure

The loss of key leaders, ineffective management and failed projects or investments can test a company's strength. Then there are operational issues, from unfavorable contracts to ineffective supply chains to insufficient capital expenditure spending.

Does management have the subject matter expertise and capacity to identify and address challenges?

Which business units aren't integral to the corporate strategy and could be candidates for a sale, wind-down or immediate closure, releasing capital and resources for use elsewhere?

Stakeholder management

When possible, it's usually better to increase transparency with stakeholders and strengthen those relationships prior to a crisis.

What are our biggest vulnerabilities?

How are we addressing any vulnerabilities so that we can ease potential stakeholder concerns and prevent possible activist campaigns?

How can we boost confidence by giving stakeholders more insight into decisions on strategy, budgeting and investments, which shows we are in control and have a plan for improved results?

Continuity and consistency in business operations

A restatement, investigation or brand issue can be a distraction that affects the business. It's important that there are people focused on continuing to run the business while those other issues are being addressed.

Have we identified a core team that will deal with the crisis?

Have we maintained a core management team that will focus on the ongoing business?

Businesses can fail for many reasons. It is important to act quickly on any signs of distress and develop a plan that helps assess the capital needs of the business and strategic alternatives available.

Working through a restructuring

If initial turnaround actions focused on revenue enhancements, cost reductions and/or liquidity improvements don't right the ship, then the board may have to consider additional alternatives. This can mean a financial restructuring of the company.

In evaluating restructuring alternatives, a board should consider not only the degree of the company's problems but also how those problems can influence the path ahead. The company's liquidity position often determines that path. In such situations, boards typically have advisors analyze strategic alternatives and develop a turnaround plan.

It's essential for companies to gather complete data in order to determine the next steps. Companies typically have multiple options, and in some cases they may try more than one. Be mindful of keeping stakeholders up to date as you make these decisions.

A company can try to **restructure and reorganize**, either in or out of court. Out-of-court restructuring is typically faster and less public and can mean lower transaction costs and fees. This may be possible if the company can pull operational levers, negotiate with creditors and target other areas for significant change.

If a company can't accomplish a restructuring outside of a formal bankruptcy proceeding, it may need to contemplate a Chapter 11 filing. That could allow it to:

- Alleviate the burden of an over-leveraged balance sheet
- Reject unfavorable contracts and leases (a strategy that may be especially attractive for retailers)
- Sell non-essential assets

Some companies may attempt to agree on a restructuring plan before filing for bankruptcy protection and go through a prepackaged bankruptcy. This can allow a company to get organized in advance and proceed through the formal bankruptcy process more quickly—sometimes in a matter of weeks or months. The shortened process can also save the company money. These bankruptcies have become more common in recent years compared to “free-fall” bankruptcies, in which negotiations and other heavy lifting occur after filing.

Another option could be to **sell part or all of the company**. One way is an out-of-court restructuring, which allows the company to use the proceeds from asset sales to deleverage, leaving it on a more stable footing. Or the sale may be part of a bankruptcy process—with a goal of boosting recoveries to stakeholders. A bankruptcy filing can also be used as a corporate finance tool to enable a quick transfer of assets to a buyer, either through a sale under the US Bankruptcy Code or through a plan of reorganization.

What happens when the above moves don’t work and a company continues to lack liquidity and access to capital? **Liquidating the company** is often the last resort. If the company is still solvent, it can attempt a wind-down outside of a formal insolvency proceeding. Although this is highly unusual at the enterprise level, it’s more common with specific business units or legal entities in the corporate hierarchy. If the company can’t manage that type of wind-down, the liquidation is often handled through a Chapter 7 filing.

What happens when companies go bankrupt?

Companies can file for bankruptcy protection under Chapter 7 or Chapter 11 of the US Bankruptcy Code.

Chapter 7: Liquidation

The company typically stops all operations and goes completely out of business. A trustee is appointed to liquidate (sell) the company’s assets, and the money is used to pay creditors first, with any residual amounts going to shareholders. Chapter 7 is typically used when there’s a lack of sufficient liquidity to finance a Chapter 11.

Chapter 11: Restructuring

Companies use this section of the bankruptcy code to try to reorganize or rehabilitate the company. The board and management typically stay in place post-filing, when the company is referred to as a “debtor in possession.” Other players are introduced to the process. These include, but aren’t limited to, an Official Committee of Unsecured Creditors, the US Trustee’s Office and a federal bankruptcy judge.

Get the complete picture when deciding whether to restructure, sell or liquidate. The board should be satisfied that management and advisors have assessed the full extent of the company’s problems and have selected the plan that will boost return to shareholders and other stakeholders.

The human element in restructuring

During a restructuring, directors and management are focused on the many hurdles to reorganizing, including assessing strategic alternatives, consummating transactions, resolving contracts and dealing with the various groups of stakeholders. Amid all this, they can't lose sight of how the process affects the company's employees.

For instance, a bankruptcy filing can affect a company's ability to pay everything from outstanding bonus awards to salaries and unvested equity awards. It can affect the value of 401(k) plans that are invested in company stock, drain the value of deferred compensation plans and make some retirement plans almost worthless.

This situation and others can affect employees' morale and desire to remain at the company—whether under a new organizational structure or as part of a sale to another company. Dissatisfied employees who leave could exacerbate the reputational risks already facing the company during restructuring. Conversely, employees who want to remain with the company but fear it may not emerge from bankruptcy could reasonably worry about their futures.

There are approved tools in a bankruptcy that companies can use to retain key talent. Key Employee Retention Programs (KERPs) and Key Employee Incentive Programs (KEIPs) are commonly used to motivate the employees who are most critical to a successful turnaround. In constructing such plans, the board should be mindful that portions of the plan will become public through court filings and should consider the impact on employees who are not included in the plan.

The board should be aware of these challenges and keep a plan to drive consistent communication and support for employees during reorganization. Maintaining a balanced tone and projecting confidence in a successful emergence from insolvency can alleviate the negative air that often permeates the bankruptcy process.

Executive and board compensation can be controversial in good times but may get even more focus when a company is in a financial crisis. The board may need to reassess the current compensation plans during times of distress.

Navigating the zone of insolvency

When is a company considered to be in the zone of insolvency? When the sum of its debts is greater than its assets and it has no reasonable prospect of maintaining its current operations. Or when it can't pay its debts as they come due in the ordinary course of business.

When a financially distressed company enters the zone of insolvency, a board's obligations may change. Those changes can be complex and boards should seek legal advice about how to help address their fiduciary duties under the circumstances.

During financial and operational restructurings, directors' approval of transactions normally comes under increased scrutiny by stockholders, creditors and other stakeholders. Transactions may benefit one set of stakeholders, such as senior secured creditors, to the detriment of stockholders and bondholders. Stakeholders who believe the board is neglecting their rights often challenge board decisions by asserting that directors violated their fiduciary duties. In other words, they sue. This is why confirming that the directors and officers have appropriate insurance coverage can be critical in situations of distress.

Stakeholders also often conduct investigations after a bankruptcy filing to determine if there's any cause for legal action against directors and officers. Defending against such claims can require significant time and money.

This area is complex and often subject to litigation by various stakeholders who are trying to boost their recoveries. And so, directors should seek legal advice when navigating the zone of insolvency. Many boards retain legal and financial advisors for expert advice in developing and executing a turnaround plan. One example is requiring solvency opinions when approving higher-risk, debt-financed transactions. Boards can also form a special subcommittee of disinterested directors to help approve significant transactions and evaluate strategic alternatives.

When your company is faced with distress, understand how your duties change and get the advice you need.

In conclusion

Despite the best efforts by management and boards, companies frequently face many financial, operational and economic risks that can bring financial distress. Boards and management should regularly monitor key performance indicators and remain alert for the warning signs of distress. Failing to react in a timely manner can greatly reduce the chances of success and also can ultimately have grave consequences. Before a company's liquidity is severely constrained, the board should work closely with management to assess the strategic alternatives available to right the ship.

Directors also face more scrutiny in times of distress, and their obligations may expand to other parties. The board should balance the often incompatible interests of various stakeholders during this time. With the help of experienced advisors, the board can manage increased risks, consider options for reorganization and successfully navigate a challenging situation.

How PwC can help:

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Governance Insights Center or Deals practice.

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