AGENDA

OPINION

The Coming Storm: Busting Five Myths that Sideline Management During a Restructiring

Directors and officers have a critical role to play in Chapter 11 cases

By Andy Dietderich | June 13, 2022

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American corporate law empowers managers to take the good faith risks necessary for leadership. American bankruptcy law is no different. The genius of U.S. bankruptcy law is its confidence in corporate managers. In contrast to the approach to insolvency in other countries — where creditors appoint receivers or courts appoint administrators — the U.S. Bankruptcy Code of 1978 introduced the concept of the "Debtor-in-Possession." Management, declared Congress, should run the show. Why this uniquely American approach? Because of a strong federal policy in favor of the reorganization of businesses (rather than their liquidation) and the wise conclusion, based on the specific history of American industrial reorganization, that current managers are almost always the best people to save their own companies.

Speak with a CEO who has been through a Chapter 11 in the last two decades, and you are likely to hear a very different story. They are not the heroes Congress anticipated. They may not even be the protagonist. Too often corporate managers feel they lose control to the advisors they hire.

It starts when restructuring professionals insist that the company appoint a "chief restructuring officer" and special independent directors from among a list of colleagues in the restructuring industry. The specialist officers and directors are typically themselves active or former restructuring professionals who are now in the business of supervising the lawyers, bankers and turnaround consultants involved in the case.

As a result, restructuring professionals oversee restructuring professionals, and a group of like-minded specialists effectively replaces the incumbent managers as the firm's strategic leaders. Experienced managers can find this immensely frustrating because they know that advisors have different incentives. Creditors and other stakeholders often share these frustrations when they see advisor-driven decisions and advisory fees out of proportion to the value created and delivered to stakeholders.

Disenfranchised during the restructuring, management is discarded at its end. According to a 2015 study, only 14% of incumbent CEOs keep their seats through a Chapter 11 reorganization.[1] Small wonder: By ceding strategy to the restructuring industry, by the end of many restructurings today, managers become strategically irrelevant.

How does the C-suite lose control of the restructuring to the restructuring advisors? As the saying goes, first gradually and then quickly. The gradual part begins with five myths, often repeated as conventional wisdom or gospel truth by restructuring experts at the outset of a restructuring. By the time these five myths have done their work, it is too late. Management has lost their leadership position and can rarely recover. Managers who want to stay in control must learn how to debunk the five myths immediately, at the outset of restructuring discussions. Only then is there an opportunity for management and professionals to form a proper working relationship, with management in charge and the advisors playing a valuable role supporting them on a well-functioning team.

Myth 1: Management Screwed Up

The first myth is that managers should not lead the restructuring because they caused it to happen. This myth is intuitively powerful. Most managers feel responsible at the time of a Chapter 11 filing and second-guess past decisions. In that state of mind, it is natural to think that creditors and the court will not want to hear from them and that it will be better for everyone if they turn the helm over to a neutral professional with clean hands.

Yet, today, the common causes of corporate bankruptcy are not management's fault. Modern bankruptcies are more likely to be the result of excessive leveraged buyout (LBO) or spin-off debt or unsustainable legacy liabilities. By the time of a Chapter 11 case, managers typically have been fighting for years to solve these or similar inherited problems. In the minority of situations in which managers actually did make decisions that contributed to insolvency, experienced creditors (and all bankruptcy judges) understand the infallibility of hindsight as well as the benefit to the enterprise of experienced hands.

In fact, some of the best-run restructurings have started with frank early meetings between managers and key creditors as businesspeople. Smart creditors know that good managers can enhance recoveries and are ready to support capable incumbent managers toward that end.

More importantly, Chapter 11 is a fresh start that can transform management's opportunity set. Managers who know their business can use Chapter 11 to solve problems they could not solve previously.

They can bolster liquidity, shed legacy contracts, discharge debts, overcome troublesome consent rights, separate assets and liabilities, estimate contingent claims, settle legacy litigation, resolve negotiation gridlocks, shutter troubled business lines, sell assets despite solvency concerns, and raise competitive debt and equity financing on better terms. They can take a company with the worst balance sheet among its peers and turn it into a company with one of the strongest.

Chapter 11 is a congressionally sanctioned process of manager redemption. What managers can achieve with the fresh start of Chapter 11 may have little in common with their struggles in the constrained, pre-bankruptcy past.

Myth 2: Management Is Too Busy to Supervise the Restructuring

The second myth can fall on welcoming ears. Managers are often under stress and juggling multiple projects during the early phases of a restructuring. In some cases, managers may find it difficult to accept the reality of a coming restructuring and will try to ignore the need for "contingency planning" by focusing on other work that is more familiar and more clearly required.

As long-term equity incentive programs become of speculative value, managers also may feel undercompensated versus peer executives at healthy companies — and not ready to take on even more work without incremental remuneration. When the restructuring industry arrives at the company and tells managers they can delegate restructuring decisions to the restructuring professionals, managers can find this proposition reassuring.

Unfortunately, delegating restructuring decisions to the restructuring industry is rarely in the best interests of the company. Restructuring decisions are some of the most important a company will ever make. Early choices can mean the difference between reorganization and liquidation or between reorganizations that harm employees and trade creditors and reorganizations that do not. In addition, a company cannot consider even a relatively simple balance sheet restructuring in isolation. A restructuring process always has important consequences for business operations, and vice versa.

For better or worse, it is the inescapable job of the C-suite to supervise the restructuring *and* do their day jobs. External resources can assist management in both capacities as necessary, but managers should be firmly in control of both restructuring and operational work streams.

Independent directors may have a role to play on special conflict matters, or even to enhance a board by adding special restructuring expertise to the team, but they are no replacement for engaged management.

Myth 3: Restructuring Is Specialized, and Management Is Not Qualified

Does management have the expertise to oversee a restructuring? Many restructuring professionals respond, "Of course not. Restructuring requires a unique set of skills and years of specialized experience. The Bankruptcy Code is complicated, and the court process births new creatures like creditor committees that can be mollified only with special techniques known to the inner circle of advisors. Bankruptcy deals are not ordinary deals. They involve unusual contracts with new types of provisions. Creditors expect new and different information. Communication strategies must change. Up is down. Down is up. The C-suite may know Newtonian physics, but restructuring happens at a quantum level where everything operates under different physical laws."

This is all untrue, of course. The CEO, CFO and GC may not become bankruptcy experts (although I have seen this happen many times), but they can learn enough to be informed leaders. Any corporate leadership team will have mastered substantive areas more difficult than Chapter 11 during their careers. It is indisputably not quantum physics. When advisory teams focus early on educating the executive team about restructuring processes, management can learn enough to separate good advice from bad advice and make solid decisions.

Educating management about Chapter 11 is critical because the restructuring industry itself has glaring knowledge gaps. Work as a restructuring advisor long enough and you learn the secret to answering restructuring questions: 95% of the time the answer has nothing to do with restructuring. What is the best way to sell a business division in bankruptcy? It is very unlikely to be the same way your bankruptcy lawyer sold a different business in her last case.

The best way to sell a business in bankruptcy is to ask the C-suite and perhaps generalist industry bankers how they would sell it *outside* of bankruptcy in order to obtain the highest price for creditors and then reverse-engineer Chapter 11 tools to achieve a similar result consistent with bankruptcy law. In many recent cases, sophisticated distressed investors, who have bought debt at a discount expecting a return on their investment, can be particularly strong allies in these process innovations borrowed from outside of bankruptcy to boost recoveries.

Good restructuring advisors know that they need an active client because the advisors' job is to use restructuring processes to achieve business objectives — not the other way around. When restructuring professionals alone set a company's strategic direction, the effort will miss issues and squander opportunities. Restructuring advisors do best when they are part of a team with informed and active corporate managers; only then is there sufficient expertise to run a restructuring.

Myth 4: The Professionals Will Have More Credibility with Key Creditors

Myth 4 takes a different approach: The restructuring professionals should be in charge because of their special relationships with key stakeholders — relationships managers do not have. Restructuring, so the myth goes, is about "consensus" even more than law. How do we get you through this? Relax. All we really need to do is get Sue X, Bob Y and Amir Z to agree. Good news: I had dinner with each of them last week, and the name of your company already came up.

The danger of this should be obvious. The restructuring industry is rife with real and perceived conflicts. Few firms pick the "debtor" or "creditor" side consistently. The largest debtor advisory practices by volume have important creditor-side practices as well, deriving substantial revenue from specific members of the distressed investment community. We all have breakfasts, lunches, dinners and industry trips together. There is nothing wrong with this. The relationships enhanced by working and playing together over the years are useful to our clients and facilitate communication.

But the restructuring industry cannot be left *alone* without management oversight on the central questions of a case. Who has the opportunity to provide debtor-in-possession (DIP) loans to finance the case? Which loan proposal is better? Which group of creditors seeking control is ahead, and which behind? How important is it to push back on the pricing of a dilutive rights offering? How important is it to try harder under the facts of the case to open up investment opportunities to third parties? Should we take an aggressive line with an influential distressed fund with a key position in our capital structure? Managers who are informed and paying attention will see that members of the restructuring industry sometimes have actual, potential and positional conflicts on these questions when they arise.

What is the answer? Less connectivity among restructuring professionals? Of course not. The answer is full disclosure and empowered clients. The C-suite should insist on full disclosure of all past, current and potential future business relationships with stakeholders and sources of capital. Then, after disclosure, the restructuring professionals must put the clients in a position to make the call that is in the best interests of all stakeholders.

In other words, the restructuring industry's special relationship with certain influential creditors is not a reason to exclude management. It is another critical reason why management, not the restructuring industry, must remain in charge of the case in order to maximize total recoverable value.

Myth 5: Letting the Professionals Handle Things Is the Way to Keep Management Safe

The last myth is perhaps the most pernicious. Management — and, for this myth, directors too — are told that turning over the keys to the restructuring industry is the best way to stay safe. Restructuring is litigious, and the creditors can be "difficult." Officers and directors should make a hiring decision and then strategically retreat. Managers who become involved in the process of Chapter 11, interfering with the work of the restructuring industry, expose themselves to greater responsibility if something goes wrong. If management and directors do not want to be a target, they should leave things to the professionals. Keep your heads down, take the professionals' advice, sign the recommended papers and hope for releases at the end of the case.

Anyone familiar with basic corporate governance principles knows that this is a dangerous approach for officers and directors today. The one thing managers should not do with important corporate activities — and restructuring *is* an important activity — is delegate blindly. Managers must actively oversee their company and remain involved. In some private company Chapter 11 cases in the past, corporate governance procedures were lax, and it did not matter. Creditors invariably agreed to release managers and directors from related liabilities upon confirmation of a plan of reorganization. Those days are over, at least for public companies and other cases of complexity.

Modern bankruptcy courts expect compliance with fiduciary principles and good corporate governance. They will hold managers and directors accountable when loose corporate governance procedures appear in larger and more contentious cases with public investors or other disparate stakeholders. Smart creditors will continue to take advantage of these errors and disrupt cases when governance is sloppy.

Managers and directors stay safe not by following the restructuring industry's playbook but by following common sense corporate governance rules. Where do these rules come from? Non-bankruptcy law. Corporate governance procedures are the same in Chapter 11 as they are outside of it. Bankruptcy case law is clear about this: Ordinary corporate law (most often Delaware's) governs the fiduciary duties of the debtor's directors and officers during a restructuring, even during the most contentious of Chapter 11 cases.

What good U.S. corporate governance procedures require above all else are three things: knowledge, involvement and disclosure of conflicts of interest. Managers and directors of U.S. companies who have no defense other than "the restructuring industry told me to" are prime targets for litigation in the coming years. If they shirk their responsibilities, they also will underserve the creditors, some of whom will become the owners of the corporation at the end of the case and all of whom have a right to active management during it.

America has the most talented corporate advisors in the world. Restructuring is no exception. Yet America has even better corporate managers. In the next wave of business insolvencies, the way to unlock the full potential of our restructuring processes — for creditors and other stakeholders — is to remember why we have Chapter 11 in the first place: so that management, and not the restructuring industry, can lead.

[1] B. Espen Eckbo, Karin S. Thorburn and Wei Wang, *How Costly is Corporate Bankruptcy for the CEO?* Discussion Paper No. 10985, Center for Economic Policy Research (ISSN 0265-8003), at 4-10. The study samples large Chapter 11 cases filed between 1996 and 2007, but few in the restructuring business would suggest the odds have improved since.