GOVERNANCE IN THE VICINITY OR ZONE OF INSOLVENCY

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COVID-19 presents a challenge that management teams and boards have not seen in our lifetimes. A pandemic case was not built into the financial projections. Supply chains were not pressure tested for the full closure of entire countries. It should come as no surprise that in the coming months some (likely a large number) of companies will become distressed. How should the board respond as increasing financial risk leads to distress? When should the board take action? We see that the board should act at the first sign of distress and that decisive action is critical to restoring solvency.

ACT AT THE FIRST SIGN OF DISTRESS

Companies operate in three financial conditions two of which are easy to define. The first is solvency generally defined as a state where assets exceed liabilities, there is more cash flow than necessary to meet obligations, and debt levels are sustainable over any reasonable forecast period. The second is insolvency which Delaware courts have generally defined to include both balance sheet insolvency (liabilities exceed the value of assets), cash flow insolvency (the company is not able to pay its debts when they come due), and inadequate capitalization (assets are not sufficient to sustain the company's business among other tests). The problem for boards arises when they are operating between these two easily (and legally) defined financial conditions. When that happens, they are in that amorphous third state that is generally called the zone (or vicinity) of insolvency.

The zone of insolvency generally involves financially distressed companies with minimal cash reserves, only marginal surpluses, increasing debt, and an inability to invest in future operations[1]. Management will know that the company has entered the zone of insolvency because access to capital is drying up, liquidity is declining, and there is little to no free cash flow. The board should continuously monitor these indicators to ensure that they know immediately that the company has become distressed.

Although Delaware courts have held that directors' duties in the zone of insolvency remain to the corporation and its shareholders[2], there are two reasons why directors should act as soon as they realize that the company is no longer solvent. First, the company is far more likely to survive if management and the board can right the ship before the company becomes

[1] Pearce II, J. A. & Lipin, I. A. (2011). The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency. ABI Law Review, Vol. 19:361.
[2] N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

insolvent. Although it is possible to return to solvency after having been insolvent, experience teaches us that is a much longer and harder road to travel than the one that leads from the zone of insolvency to solvency. Secondly, the risk of litigation against directors when a company is in the zone of insolvency increases significantly. While a company is solvent, stakeholders are often complacent. Once performance starts to deteriorate, those that have information about what is happening inside the firm start to ask questions about possible conflicts, preferences, and duties of care and loyalty. The risk of litigation can be mitigated if directors take action to return the company to solvency without delay.

TAKE DECISIVE ACTION

Here are some of the steps that the board should take.

Get the Full Financial Picture

As Jeffrey Sonnenfeld noted in "What Makes Great Boards Great", "It is…the responsibility of the board to insist that it receive adequate information. The degree to which this doesn't happen is astonishing".[3] There is no more urgent time to demand the information required to understand the true state of the organization than when it is in the zone of insolvency.

Any assessment of the financial situation should answer at a minimum the following questions:

- Are the monthly financial statement projections reasonable given the company's current financial situation, its standing in the market, its relationships with suppliers and customers, and recent historical performance?
- Are there weekly cash flow projections that accurately reflect reasonably likely inflows and outflows?
- Is liquidity being monitored and predicted on a weekly basis?
- Do the cash flow projections match the financial statement projections?
- Do the projections reflect any turnaround efforts that management is planning to undertake?
- Are there trigger points for additional actions if the current plan is not sufficient to right the ship?

Review and, If Necessary, Strengthen Processes

The board should reassess board processes as soon as the company enters the zone of insolvency because in litigation those processes can support the way that decisions were made.

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[3] Sonnenfeld, J. A. (2002, September). What Makes Great Boards Great. Harvard Business Review. Retrieved from https://hbr.org/2002/09/what-makes-great-boards-great.

For example, ensure that minutes reflect the amount of time taken to consider alternatives and the thought processes used. Furthermore, ensure that resolutions are used to formalize decisions. Sound board processes can be critical to getting better outcomes in litigation.

Assess Management's Ability to Respond to a Crisis

In order for the company to survive, management must be able to respond effectively to the crisis. The board should ask the following questions to understand management's ability to do so. Does the CEO have sufficient and relevant crisis management experience? Are senior managers able to create and articulate a comprehensive plan for recovery? Does management know which issues to bring to the board? Does management have an appropriate internal and external communication strategy? Can the CFO credibly answer questions about the expected financial health of the organization? Is management in denial? If management is not up to the task, the board may have to either engage a financial advisor who can assist or replace some of senior management with experienced turnaround professionals.

Retain Experienced Legal Counsel

The board will come under increased scrutiny as the company moves from solvency to the zone of insolvency. Legal counsel can assist in managing that scrutiny and protecting the board from inevitable accusations that come with navigating the turbulent waters of distress. As soon as the board realizes that the company might be in the zone of insolvency, the board should retain its own counsel experienced in the corporate governance of distressed companies.

Consider Strategic Alternatives

Once the board understands that the company is distressed, it should retain a financial advisor to explore strategic alternatives. Those options will usually include the sale of the company, the sale of a (or a number of) division(s) of the company, a capital raising project, etc. While this analysis can assist the board in understanding the situation, these alternatives may not be feasible as valuation is typically depressed when the company is experiencing financial problems. During a global crisis such as the one that we are experiencing now, there may also be a dearth of buyers/investors and financial markets may freeze making capital raising almost impossible.

Identify Conflicts and Act to Mitigate Them

Stakeholders commonly question whether or not the directors of a company in the zone of insolvency are conflicted and whether those conflicts are part of the reason for the company's state of distress. When there are conflicts, directors may consider resigning from the board, but resignation frees a director from neither litigation nor liability. If existing conflicts cannot be mitigated and directors have taken appropriate legal advice, consider appointing a new

independent director or a group of new independent directors and allowing them to lead the discussion on certain critical decisions.

Here are a few areas where oversight by independent directors can be the key to securing stakeholder support:

Sale of Assets - In most distressed cases that involve a sale process, an investment bank is engaged to manage the sale of the assets or potentially of the company. In these cases, a new independent director can bring much needed credibility to the sale process. It is even more critical to have an independent director lead the discussion on the sale if insiders are planning to bid for the company's assets.

The Creation and Approval of Incentive Plans - With leadership often sitting on boards that decide their own bonuses, incentive plans can appear self-serving to some stakeholders especially creditors. A new independent director alleviates that concern by providing unbiased oversight as incentive plans take shape.

The Approval of the Turnaround Plan – The appointment of a financial advisor or Chief Restructuring Officer ("CRO") does not necessarily convince creditors that the plan presented to them is credible as some stakeholders may not trust the board to which the CRO reports. The appointment of an independent director when combined with the engagement of a turnround firm can help to convince stakeholders that the plan is credible.

Directors have a critical role to play in the current crisis. Management always need the advice of corporate leaders who have a broad perspective gained from diverse C-suite experiences in various industries. At no time is that experience and perspective more indispensable than when the company faces an existential threat. Success can be achieved if the board acts quickly and takes decisive action.

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