Directors & Boards

A view from the turnaround trench

Don't let this day of reckoning completely dull our appetite for risk.

By William A. Brandt Jr.

I WORK IN THE corporate restructuring and insolvency industry, and have for almost the past 30 years. I am probably one of the few who can truthfully say that it's not been a bad business environment for my company lately, although for a variety of reasons it is not as good as some may expect. (In fact, what I do can perhaps best be described as creating flexibility for troubled companies, and this environment is a bit inflexible.) But this perspective and proximity gives me a somewhat unique window as to what is happening in Corporate America.

The headline-grabbing series of high-profile defaults and corporate scandals of the last nine months promise to change the face of corporate governance for many years to come. I want to outline what I believe are several critical issues facing directors and officers in the near future. And I want to raise several issues our policy makers must take into consideration as they confront the daunting task of proscribing remedies to our current circumstance. The consequences will be nothing less severe than a dramatic realignment of our attitudes toward risk and the potential for failure, and the fate of American entrepreneurialism.

Today, we are in the midst of an impressive wave of corporate defaults. I expect in the next six to nine months things will get worse before they get better. We are at a moment in time when interest rates, at a 40-year low, are effectively providing an artificial cushion to companies that might otherwise be teetering on the brink of insolvency. When interest rates rise, these companies will be hard pressed to survive.

Ironically, poorly managed companies will be least likely to obtain the advice of seasoned, worldly directors who could most aid them in their efforts.

In addition, we are about to confront many of the issues relating to the staggering amount of high-yield debt that has been issued throughout the 1990s. In 1991, at the peak of the last big bankruptcy market, the high-yield bond market was about $150 billion. Despite the perception that so-called "junk bonds" are a thing of the past, there is now a market of about $700 billion of such bonds, many of which will either default or mature in the next 18 months. With respect to maturity, I expect there to be few takers in the current environment for such bonds when they come up for refinancing, and feel secure in predicting that this will further the wave of balance sheet restructurings.

Finally, when the recovery truly kicks in, many companies that are currently teetering on the edge because of their association with the already filed massive bankruptcy cases (such as Enron, Kmart, Global Crossing, Adelphia Communications) will go over the precipice, unable to respond to the financing demands for new inventories. This is a classic scenario; in fact, often the strongest sign that a recovery is about to be under way is a spike in bankruptcy filings, as the manufacturing sector often lags in bankruptcy filings until a contraction has about run its course. Add to this mix the issue of asbestos — which warrants a lengthy discussion in its own right — and the insolvency industry will undoubtedly continue to do a robust trade for the next several years.

Unfortunate ladies and gents

Directors used to be a sideshow in my business. They were the unfortunate ladies and gentlemen who would formally authorize a bankruptcy, and not much else after. Being asked to serve as a director was a compliment to an es-

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teemed member of the corporate community to cap a successful career. When I would encounter them, they would either hang on for a while, their real clout usurped by creditors' committees and bankruptcy judges. Or they'd leave. End of story.

Now, it's different. Directors and officers today are just another deep pocket from which resources can be drawn by creditors who are seeking additional value to either maintain the economic value of the enterprise or enhance liquidation recoveries. This is not personal, by the way. It's simply business.

But this rise in targeted litigation has implications for the costs of insurance policies protecting directors against lawsuits. According to the insurance carrier Marsh, quoted in *The Economist* last month, the premiums for D&O insurance are up between 35% and 900% in the past year. Companies may be paying premiums for D&O insurance as high as 20% of coverage.

Three questions

This signals a looming insurance crisis. At the very least, the skyrocketing costs of insurance will prompt their own sort of reckoning. Directors who are asked to serve will be asking three major questions of their courtiers, the answers of which will in turn change the complexion of the boardroom:

• First and foremost, they will ask how much insurance coverage the company has for its directors. This will be the first litmus test, and with the insurance market as tight as it currently is, it will mean that many would-be directors will politely say "no" rather than put their personal estates at risk in the service of the company.

A subset of this first question will be: What kind of independent representation do you have for the board on legal issues? Just providing advice through corporate counsel will no longer be sufficient. If directors are to be called to account and held to a higher standard, they must have independent representation to guide their deliberative process.

• The second question will concern the number of independent directors on the board. Not only the raw numbers, but what are the expectations of independent directors? Will they be expected and encouraged to ask tough questions? Will they be given access to information to answer their questions?

These answers will create an entirely new relationship between management and independent directors. In this respect, the financial issues relating to liability may force the kind of wide-ranging reform that the corporate governance crowd has on its mind today, urging more independent directors and greater independence on their part.

• Finally, the directors will do more due diligence in evaluating the management teams with which they will work. Are we talking about cowboys, or stars? Renegades, or textbook leaders? We are already seeing many would-be chief executives posing hard questions to their prospective employers, dispatching their own financial experts to review a company's accounting practices before agreeing to take on a new assignment. Soon, board directors will be doing the same. And when they do, they may well have in mind a *Wall Street Journal* graphic from this January, which displayed the names of Enron's board of directors around the image of a conference room table.

Money versus revenge

No matter what anyone says to the contrary, throughout the world the business of insolvency and restructuring revolves around two simple issues: money and revenge. In the American insolvency regime, we have generally favored the former over the later. Sort out the money woes, chalk it up as risks inherent in a free-market capitalist system, and live to invest another day.

This viewpoint is uniquely American. In fact, in European insolvency regimes, particularly on the Continent, accountability — or, more bluntly, blame — has long carried a stronger emphasis. This, after all, is where debtors' prisons originated. To this day, in most European countries, directors may be held personally liable for the obligations created by the company on whose board they sit, if it continues to trade after becoming insolvent.

It's fairly sobering for directors to know they can be handed multimillion-dollar bills for the obligations created while they dithered and couldn't decide whether or not to put the company into a formal insolvency. Which is one of the prime reasons why bankruptcies are filed so quickly in Europe.

This liability extends past the directors, in fact. If you accept the role of an administrator in London — as I have at times — and you execute a restructuring plan on the theory that the company can be turned around, you had best be careful. If you fail, leaving the bankruptcy estate administratively insolvent, you could be held personally liable for all the debts created during your rescue attempt. Which tends to separate the men from the boys and the women from the girls. It's a "gut check."

If this sounds drastic, recognize the implications of the convergence between U.S. and European insolvency regimes that seems to be under way. The European Union, in its effort to become more competitive, is debating an historic liberalization of its bankruptcy laws. In the U.S., we are seeing increased calls for accountability.

Much of this is proceeding through our judicial system. Our system's growing appetite for revenge is best evidenced by the rise of shareholder lawsuits. According to PricewaterhouseCoopers, almost 500 shareholder suits have been filed in the past year. Make no mistake about who they are targeting: Directors are in the crosshairs.

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The result of this new diligence on the part of directors will mean a stratification into two types of companies. The top-tier, high-profile companies will draw the top directors who will ask these questions and get acceptable answers, and thus, initial comfort about their service on the board. What happens to the rest of the companies? Ultimately, they will find that they either cannot afford the insurance premiums, or they cannot pass the litmus test of top director candidates. Ironically, as a result of these circumstances, poorly managed companies will be least likely to obtain the advice of seasoned, worldly directors who could most aid them in their efforts.

Policy implications

At some point, this market disparity will rise to the attention of the federal government, and policy makers will deliberate over whether or not to provide some type of insurance pool, a la natural disasters, to cover directors. Either that, or there will be another push for tort reform to cut down on the number of shareholder suits. This will be especially so if major carriers continue to exit the D&O insurance market.

Either path has its downsides, but focus for a moment on the issue of a risk pool. In the United Kingdom, in addition to the heightened level of potential liability directors face (see sidebar), there is also a registry of directors. If a person has been associated with a failed company, they are stricken from the registry, meaning that they can no longer serve on the board of any publicly traded company until they are reinstated.

We do not have such a system here. In fact, the notion of it would give quick rise to protests. Do we really desire a government agency doing background checks on company directors? Would we really be better off with the government effectively vetting director candidates?

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It is my experience that the best kind of corporate board is composed of individuals who have assembled a range of experiences in their lives. People who have tried things. And trying invariably leads to failures and setbacks. In my opinion, we would be much worse off to have our corporate boardrooms filled with people who were dramatically more risk averse than the current incumbents.

Yet, that is one possible path down which we are headed. It is entirely possible, in this scenario, that Corporate America becomes so risk-averse as to throw away that which has made it, until recently, the envy of the world. If American entrepreneurialism and risk-taking is what has made America great, public policy makers should be very careful about how they tinker with the balance of revenge and money in the context of insolvency and corporate governance.

Of course, you may accuse me of being an interested party. It is true that I may benefit directly from the level of failure ever present in our capitalist system. But, in point of fact, I can and do ply my trade around the globe without difficulty. These observations are made with bigger concerns in mind.

This wave of scandals is prompting serious introspection on the rules of the road of our capitalist system. Chief executives and senior managers have misled investors. The barbarians are at the gates, and are requesting their pound of flesh. Certainly lawbreakers must be held to account. But the key for directors and public policy makers is not to serve up so much red meat as to completely dull our appetite for risk and failure. For these two elements have been essential parts of America's greatness. ■

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