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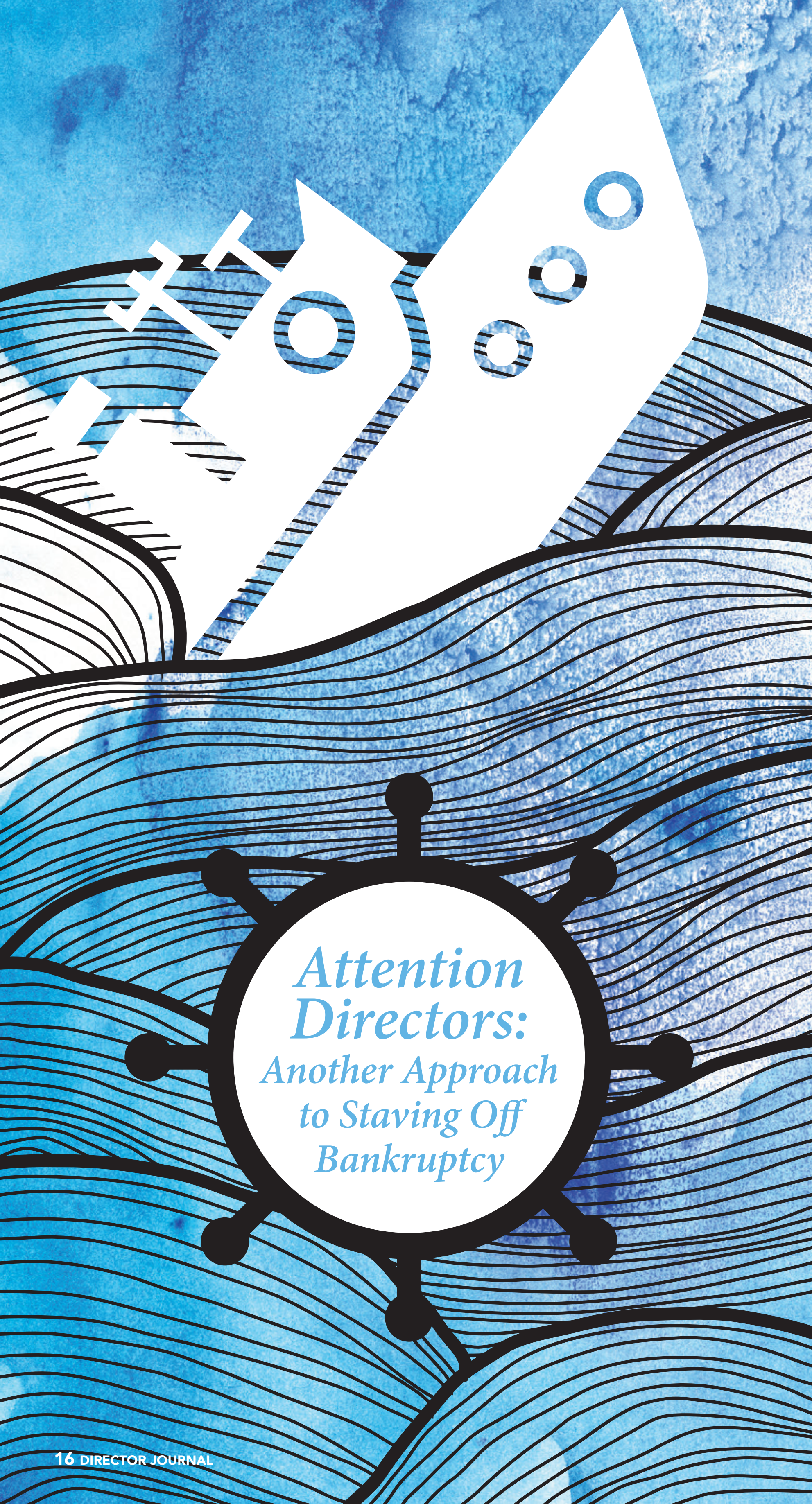

Attention Directors:

Another Approach to Staving Off Bankruptcy

Look beyond personal liability and consider an informal restructuring

It is every director's worse nightmare: the company of which they have been a duly appointed steward finds itself insolvent. It is not a scenario any director ever contemplates before joining a board, yet it is a scenario in which many directors will find themselves.

Dealing with a potential bankruptcy is not an event for which many directors sign on. And, unfortunately, it is often the juncture when many directors will call it a day, especially upon learning of the potential liability.

Yet, as a director, this is precisely the time when you are most needed. This is the time when the CEO and his or her management team will need to lean on directors to help right the ship. This is the time when lenders and shareholders most urgently require the board's input, commitment and work to save and protect their investment.

When a company is in financial distress the first thing the board should do is to review its liability. A company is its own legal person and, generally, directors have no personal liability related to their involvement. Although there are some laws that impute liability to directors, in the context of insolvency there is one domain of vulnerability: directors are personally responsible for unpaid deductions at source to employees and unremitted goods and services tax. Any director can check with the CFO anytime on whether or not the company is complying with its obligations.

To deal with any residual, post-financial-distress litigation, most companies have a directors and officers liability insurance policy that may offer some protection since the insurer will have the duty to defend.

But, as any director who has been through a restructuring knows, it's not as simple as merely assessing personal liability. Directors have to work with a highly stressed management team to work through difficult balance sheet issues. Frayed nerves and bruised egos affect the process of trying to make good decisions, successfully implementing and executing new strategies and revising business plans. It requires a cool head, lots of creative and lateral thinking and nerves of steel.

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Insolvency is defined as when a company's liabilities exceed its assets and when it cannot meet its obligations as they become due. This is the state in which many small companies exist more frequently than is commonly appreciated. The majority of small and medium sized companies have, at one time or another, been close to insolvency or were in fact "legally" insolvent.

Yet, this "technical" insolvency need not be the end of the line for a company. It is only a reflection or snapshot of a given moment in the company's financial history. It doesn't mean that the business model is not sound or that there is no hope for a changed situation. It means that for a reason such as a steep drop in a commodity price for an energy or mining company, or the loss of a large contract or customer in the case of a manufacturing concern, that a company finds itself with too much debt and off-side regarding its loan covenants. This is when warning bells are sounded, and they are even more alarming when the company cannot meet its obligations as they become due. There are a myriad of other issues that may lead a company down this road.

This is the moment when the board and management must devise a rescue or go-forward plan. Debt can be reduced by replacing existing obligations with new debt that has a longer payback period or a lower interest rate. The debt may also be paid off with the cash proceeds from an equity raise. If neither of these remedies are available, then management and the board must attempt to convince creditors to postpone their debt or even convert their loan into equity.

The goal is to save the company. By doing so, more of the value of the loan and the equity is preserved. Bankruptcy wipes out equity holders and generally offers pennies on the dollar to lenders. It is the poorest outcome.

Frequently, when a company is in financial distress, it enters into a restructuring mode under the auspices of a court from which it has sought protection from creditors. In return for providing the company time to reorganize its affairs, the court also appoints a trustee, typically from an accounting firm, to monitor and direct a company as it attempts to renegotiate the terms of its loans from lenders and its debts to suppliers. This is known as formal restructuring.

But there is an alternative. Much of this work, if not all, can be executed by management and the board through an informal restructuring mode. Formal restructuring is seen as attractive because it puts into place a process and an impartial custodian in the way of a monitor or trustee. Yet, management and the board have the opportunity in many cases, as long as trust in them has not been completely breached by circumstances, to approach creditors with solutions and a plan.

Nobody knows a business better than its CEO and his or her management team and board. Rather than having a court-appointed monitor or trustee, who is unfamiliar with the company's business, better to work with the existing executive team and board. This is the moment when directors can be of the greatest value and make the greatest contribution. Sometimes a company just needs the help of experienced and less-emotionally involved directors to see and organize a solution and plan. The directors, who are uninvolved in day-to-day operations, are in a unique position to offer enormous value in this context.

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MICHAEL JUDSON, ICD.D, has more than 25 years of experience forming, financing and operating private and public companies. He sits on the boards of two Canadian public companies and is managing director of Judson & Cie, a financial and restructuring advisory firm.