FTI CONSULTING

Navigating Today's Environment

The Directors' and Officers' Guide to Restructuring

SECOND EDITION

Michael Eisenband
Consulting Editor
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AMERICAN BANKRUPTCY INSTITUTE

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CHAPTER EXCERPT

8.I DISTRESSED COMPANY COMMUNICATIONS: MAINTAINING CREDIBILITY WITH KEY CONSTITUENCIES

LEGAL PERSPECTIVE

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Either in or out-of-court, a successful restructuring requires the support of creditors and other key constituencies. Therefore, when addressing financial distress, directors and officers should be mindful of more than just legally required disclosures. This chapter provides an overview of the strategic benefits that transparency can bring, as well as certain pitfalls to avoid.

Be appropriately transparent with creditors

Usually, the most important constituency that directors and officers must deal with in a distressed situation is the company's creditors. Negotiations with creditors may result in solutions such as longer payment terms, covenant relief or other amendments to debt agreements that will allow the company to meet its obligations. Creditors are more likely to agree to these concessions when they believe the company is transparent about its financial situation and the challenges it is facing that have led to the distress. Transparency and consistency in communication with creditors can, in turn, give creditors confidence in management and their turnaround plan — a key driver of achieving a successful workout or restructuring out-of-court. Bankruptcy can be a costly, time-consuming, uncertain and contentious process; if it can be avoided, it is usually in the best interests of both the company and its creditors to do so.

As a condition to granting a short-term forbearance or any long-term concessions, creditors will generally require more detailed and frequent reporting from the company than the company is accustomed to, particularly in the beginning stages of the workout. This may include monthly or weekly financial reports, management calls and reports from financial or other restructuring advisors to the company covering metrics of interest to the lenders. Lenders will typically want to monitor the company's financial situation closely during the entire period of financial distress — and for some period thereafter.

[1] The authors thank Nicholas A. Dorsey, Capital Markets Partner, and John A. Marcin, Corporate Associate, for their contributions to this chapter.

Be mindful of creditor group motivations

Not all creditors are motivated to achieve a successful workout or restructuring that allows the company to continue as a stand-alone going concern. Some may want to take the opportunity to acquire equity control of the company, some may be looking for a short-term bump in debt trading prices that allows them to trade out of the name at a profit and some may be looking to trip a "credit event" to benefit from a position in credit default swaps or other derivative financial instruments. The potential motivations are practically endless, and undisclosed positions can impact motivations in ways that are not transparent to the company and its management.

Due to the varying interests and motivations of different groups of creditors, a company in distress must be careful not to divulge information that could be used to benefit a creditor group at the expense of the company. For example, while traditional lenders such as banks are typically more interested in maximizing recoveries in a going concern workout, hedge funds and activist debtholders may be more likely to pursue short-term strategies, backed by the threat of triggering or calling defaults and forcing a company into bankruptcy, as well as various "loan-to-own" strategies.

In addition, a company should not disclose projections to financial creditors that overstate the degree of the company's distress in an attempt to extract concessions from financial creditors, while at the same time disclosing relatively optimistic projections to its suppliers and trade creditors to keep them comfortable with continuing to do business with the company. The company should take care that its internal planning projections are consistent with what it is disclosing to its creditors. To the greatest extent possible, when making disclosures — either publicly or in private negotiations — those disclosures should be consistent in order for a company to maintain its credibility with all parties. This is an area where a company in distress can benefit greatly from a competent restructuring financial advisor and legal counsel to maintain a single source of consistent financial and legal disclosures throughout the process.

A delicate balance must be struck in determining *what* should be disclosed *to whom* and *when* in order to negotiate effectively both with creditors whose interests are aligned with the company's as well as those whose interests may not be. Of course, no creditor group is likely to have interests that completely align with management, so directors and officers must be thoughtful about the timing and content of disclosures to navigate the period of distress successfully.

Disclosure of raw information without context may do more harm than good. On the other hand, lenders to distressed companies generally hate surprises and feeling that they are being kept in the dark, so sometimes information must be disclosed promptly to maintain trust and credibility. There is no one-size-fits-all solution for every situation. Experienced restructuring counsel and financial advisors can assist in navigating these situations and help guide the best course of action considering a company's particular creditor constituencies and circumstances.

Make factual and reasonable projections

Financial distress imposes enormous pressure on directors and officers, and management may be tempted to "project" its way out of distress by telling the lenders what they want to hear with unduly optimistic projections. This strategy rarely (if ever) works. Aside from setting themselves up to disappoint and lose credibility with the lenders, directors and officers may face liability for making overly optimistic or simply untrue statements regarding the company's prospects and ability to satisfy its obligations. The better approach is to present reasonable base, upside and downside projections so that management and the company can maintain the trust of its lenders over time by delivering on what they promise.

The board will need to take a more active role during a period of distress, including approving management projections and material communications with creditors. Experienced legal counsel and financial advisors are indispensable to ensure that these communications are appropriately vetted and contain both the appropriate level of detail and appropriate disclaimers.

Consider a chief restructuring officer or special committee

While this chapter emphasizes the importance of maintaining creditor relationships through appropriately transparent communications, sometimes those relationships have already been significantly damaged and need repair. In such cases, a company may benefit from appointing a chief restructuring officer ("CRO") and/or a special committee for restructuring matters. Those appointed should be independent and free from conflicts to instill confidence in creditors.

Even where relationships with creditors are relatively good, a company can still benefit from a CRO or special committee, as there are many experienced professionals in this area who have encountered similar situations and have often negotiated with the same or similar creditors to reach a successful result. This frees management to focus on running the business, while the CRO deals with restructuring the balance sheet.

If a company decides to appoint a CRO or special committee, creditors will want input on the persons appointed. They may insist on approval rights as a condition to a forbearance agreement or other arrangement. Whether the creditors have the right to approve or not, seeking creditor input may pay dividends as settling on a mutually agreeable CRO or special committee will start negotiations on a positive note. The right CRO can provide much needed credibility that will redound to the benefit of the company and all its stakeholders.

Transparency may be inevitable

If an out-of-court restructuring cannot be accomplished, a bankruptcy filing may be necessary. A fundamental principle of bankruptcy is the public and transparent nature of the process. All filings in a bankruptcy case are public, with only the narrowest of exceptions, and companies in bankruptcy are required to file detailed financial reports every month, which will be scrutinized by creditors, the Office of the United States Trustee (a division of the Department of Justice responsible for the oversight of the bankruptcy process), the bankruptcy court and the public.

In addition, any transaction that is "other than in the ordinary course of business" is subject to the approval of the bankruptcy court, after notice to all creditors and interested parties of the details of the transaction, which must be filed publicly on the court's docket. Courts are extremely reluctant to grant requests to redact information from such filings. Once the bankruptcy petition is filed, directors and officers should understand that the company will be operating in a "fishbowl" environment.

Directors and officers must also be mindful of any communications in open court, particularly by its restructuring counsel. All court hearings are public and closely followed by the financial and restructuring press, who will often report the proceedings on a real-time feed or live blog. While it is not possible to fully script this messaging as counsel responds in real time to questions from the court and other developments during a court hearing, management should coordinate with counsel in advance of major hearings to make sure the board and management are comfortable with the overall messaging of counsel's expected presentations to the court.

Be appropriately transparent with vendors, employees and customers

In addition to creditors, a company's vendors, employees and customers are other critical constituencies to whom a distressed company's communications must be carefully considered. While it is important to resolve a distressed company's balance sheet, the company's operations must also be maintained and improved where necessary to ensure long-term viability and success.

Upon learning of a company's distressed situation, each of these constituencies may become hesitant to continue dealing with the company. Vendors may insist on shorter payment terms, less flexible payment options or even cash-on-delivery. Employees may fear layoffs, leading to an employee exodus and damaged employee morale and productivity. Customers may be hesitant to make purchases if they are unsure that the company will deliver or maintain its products.

Directors and officers of a distressed company should be proactive and get in front of any reports of distress by communicating clearly to these constituencies and clarifying the company's liquidity position and its plan to address the issues it faces. Again, a delicate balance must be struck. A company should disclose enough detail to convincingly reassure these constituencies without jeopardizing its negotiating position with financial creditors. However, as discussed, a company must be careful to avoid providing unduly optimistic statements and projections to any constituency.

There is also a sequencing aspect, as reaching agreement with the company's main financial creditors may provide significant comfort to its vendors and employees.

Required disclosures

Importantly, a bankruptcy filing does not relieve a public company of its reporting obligations with the Securities and Exchange Commission ("SEC") unless and until it has deregistered. However, neither the New York Stock Exchange nor the Nasdaq provide for automatic delisting upon a bankruptcy filing. Therefore, in addition to the categories of communications already described, there are several required disclosures that directors and officers of a distressed company should keep in mind.

Going concern disclosures

The rules of financial reporting generally require a discussion by management of a company's financial situation. In the past, accounting rules required auditors to report when a company may be unable to continue to meet its financial obligations; however, there are now rules requiring management to assess whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the company's ability to continue as a going concern within one year after its financial statements are issued. Sears was one of the first high-profile companies that made such a company management "going concern" disclosure in its annual report filed in March 2017; Sears filed for Chapter 11 protection 18 months later.

Regulation FD and cleansing disclosures

While communicating with creditors is necessary for companies facing covenant defaults or other financial distress, public company management must be mindful that, pursuant to SEC Regulation FD, any material non-public information ("MNPI") shared with outside entities — unless subject to strict confidentiality obligations — will need to be furnished concurrently to the public via a broadly disseminated press release or a filing with the SEC.

One typical method to avoid immediate disclosure of such information to the public is to have creditors agree to receive information under a non-disclosure agreement. However, creditors are often reluctant to become restricted from trading due to knowledge of MNPI, and typically require an outside date by which any MNPI must be disclosed publicly, hence "cleansing" the creditor of any MNPI-based trading restrictions. These cleansing disclosures are unlike periodic disclosures management is used to making, and typically involve the disclosure of term sheets or presentations relating to restructuring proposals and the like. This is another area where experienced counsel and financial advisors can help guide the company.

Distressed company disclosures

Companies required to report with the SEC must make appropriate and timely disclosures in their periodic (quarterly and annual) reports. In addition, disclosure of material interim developments may be required under the securities laws or stock exchange rules or otherwise be appropriate under principles of good corporate governance. Matters that should be disclosed may include liquidity issues, inability to make interest payments on bonds, pending lawsuits that could have a material adverse financial impact on the company and the need to engage in restructuring discussions. While these are often initially couched in terms of "evaluation of strategic alternatives" or similar language, once it becomes clear that a bankruptcy filing may be required, the company should disclose that specifically. The specific disclosures will depend on the company's specific circumstances but at the relevant time appropriate disclosure must be made or the company may face claims under the securities laws in addition to whatever other problems have led to its financial distress. These securities law claims can complicate the Chapter 11 plan process.

Non-public companies facing financial distress generally have greater flexibility in terms of the timing and nature of disclosures but, for the reasons discussed in this chapter, they should also keep their creditors and other constituencies reasonably informed of important developments.

A cautionary note on distress signaling

Certain actions of a distressed company's management may inadvertently signal to creditors — and the market as a whole — that the company's situation is deteriorating toward bankruptcy. One key signal is the filing of a Form 8-K with the SEC announcing the payout of large off-cycle bonuses to management. The market has come to view these types of 8-K filings as a clear signal of a pending Chapter 11 filing.

Companies should discuss with legal counsel any contemplated actions that may inadvertently (or prematurely) signal distress to the market and unnecessarily damage relations with creditors, customers and employees at a critical stage.

The bottom line is that distressed company disclosures — like all company disclosures — should be timely and accurate. The increased scrutiny that comes with financial distress means that more attention and thought needs to go into the communications plans and protocols of distressed companies. The board needs to more actively manage the process with the assistance of experienced outside legal and financial advisors and, where appropriate, communications specialists.

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