Hip Pocket Injuries in Workouts: Prevention in Practice for Advisors

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1. Introduction

1.1 Shadow Directorship – Crossing the line

Parties associated with an entity in financial difficulties (see Appendix I) will have differing levels of involvement and knowledge as to the entity's status and future prospects. To illustrate, a financial institution and/or advisor monitoring an entity's position may have in-depth knowledge of short term cash flow projections and the financial position, whilst trade creditors are likely to have considerably less knowledge of the entity's financial status as a whole.

Inevitably there are dangers for those parties who become too closely involved in the ongoing management of a distressed entity. But what constitutes crossing the line? And what are the consequences of crossing that line?

1.2 Duties of directors

In general terms, the legislation in relation to companies imposes certain duties on directors to:-

- act in good faith and in the best interests of the company; (s 131)
- exercise powers for a proper purpose;(s 133)
- not carry on the business in a manner likely to cause substantial risk of serious loss to the company's creditors; (s 135)
- not agree to certain obligations; (S 136) and
- exercise powers and perform duties with the due care, diligence and skill of a reasonable director. (S137)

The sections referred to above are those of the New Zealand Companies Act 1993, however these are largely mirrored by the provisions of the Australian Corporations Act 2001. For the purposes of this paper we refer to the New Zealand legislation.

1.3 Who can be held to account?

Like the equivalent provisions of the Australian Corporations legislation, section 126 of the Companies Act 1993 (New Zealand) does not include the specific term "shadow director" in its definition of director. In both jurisdictions, a director is not only someone who holds that title but can include those with whose directions or instructions a director may be required or is accustomed to act. Shareholders can be held to be director but receivers are specifically excluded from the definition. In addition professional advisers are also excluded in those circumstances where they act solely in their professional capacity.

Deemed, de facto or shadow are all terms applied to those who effectively act in the role of a director. Each definition may be summarised as follows:-

- Deemed – a person to whom a director's power or duty has been directly delegated by the board with that person's consent.
- De facto – someone who is not formally appointed as a director but who acts as such or is held out to be a director.
- Shadow – someone in accordance with whose directions the directors of the company are accustomed to act – ie the "puppet master'.

It is the position of shadow directors in a restructuring which is of interest in this commentary.

It is not unusual for a financial institution to provide ongoing financial support to a customer subject to certain conditions being fulfilled by that customer. Commentators caution that there is a fine line between legitimate requirements designed to protect a financial instituion's position and shadow directorship.

New Zealand, Australian and English jurisprudence have raised common themes when considering the position of a shadow director. When assessing if an individual is a shadow director, the Courts have generally considered:-

- The extent of control exerted by the individual (***Re Tasbian Limited (No 3) [1992] BCC 358)***
- Whether the individual exercises real influence (***Secretary of State For Trade v Deverell [1999] English Court of Appeal)***
- Whether there is a "pattern of behaviour in which the board did not exercise any discretion or judgment of its own but acted in accordance with the direction of others." ***(Re Hydrodam (Corby) Limited [1994] 2 BCLC)***
- Whether the shadow director showed a "willingness and ability to exercise control and an actuality of control over the management and financial affairs" ***(Standard Chartered Bank of Australia V Antico)***
- Where the source of decision making is located within the corporation (***ASC v AS Nominees Limited (1995) 13 ACLC).***

There has been no specific case yet where a financial institution has been held to be a shadow director however the Courts have indicated a willingness to make such a ruling if the circumstances warrant it. Professional advisers may take some comfort from the specific exclusion contained in both the New Zealand and Australian legislation The potential blurring of the boundaries however between professional advice and instructions when dealing with a financially troubled entity, may lead to that professional being found to be a shadow director.

In essence the degree of involvement in decision making and strategic management of a company will determine the true extent of the risk faced. The old adage that with power comes responsibility is equally pertinent in those situations where creditors and their advisors become more intimately involved with the ongoing operations of a financially challenged entity. The greater the involvement the higher the probability that individuals will be held to account if the company subsequently fails.

1.4 What are the consequences of crossing the line

Individuals, who are found to be shadow directors, will be subject to the duties imposed under the legislation and failure to comply can lead to potential personal liability claims. Outside of a formal insolvency (liquidation), "directors" can only be held to account for breaches of duties on the application of the company.

That position, however, changes significantly if a company is placed into liquidation. Section 301 of the New Zealand Companies Act 1993 allows the liquidator and creditors, as well as shareholders, to apply to the Court for an order that a director, amongst others (such as those involved in the formation and promotion of the company, manager, receiver and liquidator) repays or restores money or property.

Whilst section 301 does not constitute a cause of action in its own right, it provides a process of recovery from those whom the Court, in its discretion, finds guilty of their breaching duties in relation to the company. Where more than one director is involved the Courts have tended to apportion liability in line with the degree of involvement and culpability and the duration of involvement.

Sections 592 -594 of the Australian Corporations Act imposes a specific duty on directors to prevent the company incurring debts while insolvent. Like its New Zealand counterpart, Part 5.7B of the Corporations Act was enacted to facilitate the recovery of property or compensation where a director breaches, to the detriment of the company and its creditors, the statutory duties owed to the company.

To summarise – beware the level of involvement in the restructuring of a financially distressed company. If the anticipated outcome does not eventuate, a shadow director may be required to dig into his/her own pocket should an aggrieved party seek recompense for losses arising during his involvement in the company.

2. Restructure involvement and corresponding risk

To illustrate the risks and actions which can minimise exposure to advisors, the following is a real life example of a recent restructure process undertaken on a group of entities. Due to confidentiality and commercial issues, we clearly cannot reveal the identity of the parties involved in the restructure process

2.1 Step 1 – Business Appraisal

Engagement

Before undertaking the business appraisal (also referred to as an independent appraisal or investigating accountant's report) we first agreed the terms of reference with the appointer, which is recorded in a letter which also defined the scope of the engagement. The letter is then countersigned by the appointer (the entity concerned) to confirm their agreement with these terms.

- *The terms of engagement set the scene for the involvement of the advisor, including responsibilities and scope*
- *Wording and terms used in the document must be consistent with an advisory role and not indicate that findings will determine the outcome, but that recommendations will be passed to the entity to ensure clarity of the various roles*
- *The engaging party is an important consideration. It is preferred that the advisor be appointed by the board of directors of the entity concerned as opposed to a stakeholder such as a bank. This further reinforces that the decisions and corresponding responsibility remain with the entity.*

This then enabled us to plan the assignment and ensure that we had the right level of staff. From there we obtained various information including monthly reports and other information, analysed the information, interviewed key staff members and prepared our report.

Key findings from the appraisal

- Governance was non existent, there was only one director, and there were no regular monthly board meetings. Governance is one of the key issues we look at when we review a business. For a business that size we would have expected that there would be formal monthly board meetings, board reports a number of directors with difference skills sets and preferably non executive independent directors.

- The CEO was very much hands off and left the day to day running of the group to business unit managers. His focus was very much on a potential merger. This was another fundamental weakness.

- The Financial Controller was acting as CFO pending a new appointment. Information did not flow to us in a timely manner and so the process took longer than scheduled. A business of size needs an experienced CFO.

- The senior management team was weak (with a few notable exceptions). There were limited regular meetings and the senior managers were not fully au fait with the overall position of the group. Again this was a fundamental weakness.

- The business had grown rapidly by acquisition but the businesses had not been integrated. As a result there were a myriad of different systems and processes all of which added complexity and cost to the business.

- Important figures in the balance sheet had not been reconciled and the position was so bad that no one knew with certainty the true financial position of the group.

- A full consolidated balance sheet was not prepared. The problem with this was that we were unable to see the whole picture. Once we got to the bottom of it we identified that debt levels were excessive and the balance sheet was to all intents devoid of equity.

- Constructive trust issues were identified. Some customers had paid in advance for services. Strictly speaking the entity was not entitled to those funds until the service had been provided. In fact the funds were utilised before the services were provided.

> - *Good policy in preparing reports should include a full review with the entity prior to finalising and distributing to any agreed third parties to eliminate/correct any misstatements or misinterpretations.*
> - *Standard reports should also incorporate both the original engagement letter and terms of engagement, a clear description of the limitations of the report and reliance upon information provided by the entity, and also set out the directors' legal obligations and associated risks.*
> - *All reports should be checked for consistency with the scope and terms of the engagement to ensure that all areas are covered and that the advisor has remained within the boundaries of the scope.*
> - *Any recommendations should be stated accordingly and reinforce that any decisions remain with the board.*

In the case of this report, we had anticipated that the CEO may challenge the findings of the report, however this did not occur. As noted above, focus was directed on the merger which he believed would resolve all of the issues. As a result of the report a new CFO was appointed to deal with the so called day to day issues identified by us whilst merger negotiations continued.

2.2 Development of Restructure Plan

At the request of the CEO, we met with the proposed merger partner. In a lot of respects the merger made sense as it would enable the combined entity to improve performance by cost savings through synergies and being larger it would have a stronger negotiating position with key suppliers. Having met the merger partner we formed the view that they were looking for a bargain, that the merger was a long shot and, therefore, the business would have to stand on its "own feet".

- *When advisory work is extended past an initial reporting engagement it is essential that the scope of the extension is documented and agreed between the advisor and the entity. This may take the form of an entirely new engagement document or an agreed alteration of the original scope which refers back to the original terms and conditions.*
- *When meeting with third parties it is essential to make clear your role as advisor and not make any representations as to decisions which rest with the entity.*

The new CFO tried to develop a short term cash flow and produce better business reporting, but struggled. Many tasks seemed to be incomplete, mainly due to attempts to over-engineer everything.

The key thing learnt throughout this process was the need to keep it simple. The cash flow was going backwards but we were unable to determine from the information provided whether this was due to trading losses or working capital movements. Weekly meetings were scheduled to review progress. There were two consecutive instances where these meetings were stopped because the then CFO was unable to provide meaningful information on cash flow.

The situation came to a head when, at one of these meetings, the CFO advised he was struggling with the cash flow because the group had no debtors ledger, when in fact it did. Clearly the appointment was not working out. The CFO had lost credibility, particularly with the group's bankers and so had to go. This is one of the key aspects of a restructure – it is essential that the stakeholders have confidence in the CFO. If not then it is hard to see how a restructure could succeed.

- *Working with management and staff in the preparation and review of financial information is an area of risk.*
- *It is important to reinforce that any information produced must be the product of, and endorsed by, the entity and does not represent the work or opinion of the advisor.*

Following the business appraisal, we had a business that had no governance, a CEO focussed on a merger that was unlikely to work, no CFO, negative cash flow and no equity. Our analysis showed that there was one part of the business which we believed was a viable core business, but it was being swamped by other parts of the business which were clearly unsustainable. Something radical was needed so we assisted the company to devise a restructure plan based around:

- Appointment of a new CEO
- Appointment of a new CFO
- Set up of a "newco" and "oldco" structure
- Sale of underperforming businesses with proceeds applied to retire debt
- Hive down of the viable core business into "newco"

- Driving cost reductions in "newco"
- Set up of a "newco" trust account to hold customer receipts paid in advance
- Wind down of the residual "oldco" business in a controlled manner
- Seeking additional funding from bank to support "newco"

The determination to implement an "oldco"/"newco" structure was based upon the fact that the quality of the information was so poor that there was a high degree of information risk. Therefore, it was decided to sell or wind down each of the non performing businesses in a controlled manner, with the viable part of the business hived down to a "newco" so that it could trade in a "clean" entity. This would allow greater certainty around the information flows.

- *It is vital when assisting an entity with the development of a restructure plan that multiple options (where available) are presented with likely/estimated outcomes to enable board/management to make informed decisions as to the best way forward.*
- *Throughout this process the advisor must maintain a supporting role, ensuring that all stakeholders are considered along with the directors' duties and obligations under law*

2.3 Implementation of Restructure Plan

The new CEO had recently joined the group at a senior manager role. In the course of our earlier business appraisal it had become apparent that that person had the skills needed to be CEO. This was a critical judgement but one that proved right. There was no one in the organisation with the necessary skills to be CFO and so that person had to be recruited. Again the decision as to which person to employ was a critical decision for the restructure. The new CFO, with industry experience, quickly got on top of the position.

Again, one of the critical elements of the restructure was the appointment of the new CEO and CFO. They are responsible for the development of a business plan, and ultimately the implementation thereof. They are the key to any restructure. The company was fortunate in that it was able to secure an outstanding CEO and CFO. The former CEO, once he came to realise that the merger was unlikely, was generally supportive, as he could see opportunity to preserve the viable part of the business and add value.

The new CEO formed a senior executive team, gave them a frank assessment of the group's position and shared with them the way forward. They were given specific roles and accountabilities and were expected to share these with staff members so that everyone had a clear picture of what was required. The CEO was also instrumental in changing the culture within the organisation, which is something that should not be underestimated. The new CEO was able to build strong and credible links with the industry, key suppliers, customers and the bank. All of this sounds easy but it wasn't. Without the dedication and commitment of the CEO there were serious questions as to whether the business would have survived.

- *Due to good management being essential in any restructure these processes often include recruitment for senior appointments. It is important to ensure that should an advisor be involved in this process the merits of each candidate are presented objectively to the board/senior management and that the final decision of appointment rests with the entity.*

The under performing businesses were sold or wound down in a controlled manner, rather than through the appointment of receivers or other formal insolvency processes. The nature of the businesses was such that the underperforming parts of the businesses would be of little value in an enforcement scenario and would have had a significant negative impact on the value of the viable ongoing part of the group. Furthermore there were complex issues around constructive trust. In any case the industry dynamics were such that even the underperforming businesses had a strategic value to other industry players as a going concern, which was worth more than break up value.

Accordingly the plan was to simply sell off the under performing part of the group. Unfortunately there was a second ranking security on the under performing part of the group, so the group and the first ranking security holder sought their consent to sell the businesses. The second ranking security holder refused to release its security, unless it was paid a certain amount, even though it clearly had no security value. With the support of the first ranking security holder, the company offered what was thought to be a reasonable amount to buy them out but they declined and threatened to proceed to Court to liquidate the company. Had they proceeded we believe it would have put the whole restructure at serious risk. Therefore another solution had to be found.

As a last resort and after seeking specific legal advice, the company requested that the first ranking security holder take possession and sell the assets under sections 109 and 114 of the Personal Property Securities Act ("PPSA"). The basic principle of these sections is that security holders can take possession and sell underlying assets over which they have a prior charge, without notifying any subsequent charge holders. The relevant wording of section 109 and section 114 is as follows:

- *S109 (i) states "A secured party with priority over all other secured creditors may take possession and sell collateral when (a) the debtor is in default under the security agreement or (b) the collateral is at risk"*

- *S114 (2) provides an exclusion of the need to inform other secured parties if amongst other things "the secured party believes on reasonable grounds that the collateral will decline substantially in value if it is not disposed of immediately after the default".*

The first ranking security holder was reluctant to appoint a receiver given the potential for damage to the rest of the group. It simply used the provisions of section 109 of the PPSA and acted under its security to sell the assets to a third party. It was important to note that the s109 procedure did not have to be publicly notified. The purchaser was fully informed throughout the process and had the benefit of good legal advice, so was prepared to proceed.

As no notice was required the second ranking GSA holder was advised after the sale was completed. Needless to say, they were "disappointed" with the result. However, it was important that the reputation of the group's brand was not damaged and in any case the second ranking GSA holder could have liquidated the company concerned. Therefore, negotiations continued and eventually settlement was agreed. Once that was done the old businesses were wound down in a controlled manner.

- *Where legal issues or conflicts between stakeholders arise it is essential that independent legal advice is sought prior to any decision being made.*
- *The need to obtain independent advice is particularly important in scenarios which do not have prior precedence or fall within a specialist area. This is often the case with recently enacted legislation such as the PPSA in New Zealand.*

Concurrently with the above activities the remaining viable business were hived down to a new legal entity. As stated earlier the new legal entity was used to enable the business to start afresh and therefore avoid the information risk of the old companies.

One of the important steps taken was to complete a cost reduction exercise to reduce costs, particularly in the ongoing newco business. This involved tighter control of discretionary spending on things like phones, expenses, advertising etc. But more importantly there was a lot more emphasis on things like pricing, margin management, and simplifying the business to reduce costs. The ability to cut costs and focus on revenue and margins was crucial in that it gave the group some additional initial cash flow whilst proceeding with the restructure.

- *A successful restructure process where past mistakes are not repeated requires close examination of cost structures and maximisation of cash flows. However advisors in these scenarios must be careful to identify opportunities and make recommendations only and must not be seen to be dictating cost cutting measures to management.*

As mentioned earlier, the group received payments in advance from its customers. Legal advice confirmed that the funds were in essence held on trust and so should have been held in a trust account. However they had been banked into the group's overdrawn bank account. The issue arose around the same time as the liquidation of a brokerage firm where funds held "in trust" were utilised for working capital requirements, and the bank concerned did not want to face similar issues. As part of the restructure the bank provided sufficient funding to enable the group to restore the trust account to the position it should have been.

The bank was "prepared" to consider additional debt as long as added value through a restructure could be demonstrated. This illustrates that banks are prepared to consider different funding structures as long as there is a reasonable return for the risk. The additional funds provided by the bank were in essence equity.

The new CEO and CFO prepared a three year business plan which showed the growth opportunity and their plans to achieve the target. At the request of the bank we then independently reviewed the business plan and concluded it was viable, and if successful would generate increased value to all stakeholders. On that basis the bank, after careful consideration, supported the restructure.

As part of the restructure plan an incentive scheme was proposed in which all stakeholders would share in any upside. This was to be split between the bank (in consideration for their continued support and additional funding, the previous CEO the new CEO and CFO). This was a difficult issue to manage given the different interests and expectations of the different stakeholders. The reality was however that the bank was providing what was in effect additional equity and therefore should get an equity return. It was also important to ensure that the new CEO and CFO were incentivised to deliver on the restructure plan and share in the upside. The old CEO on the other hand wanted to preserve as much of the upside as possible for himself. This was one of the hardest aspects of the restructure to resolve.

- *Presentation of forecasts when seeking additional funding must come from the entity and its management.*
- *Such information may be accompanied by commentary from an advisory but this should not categorically verify or endorse the information being presented, merely comment on source, basis and comparisons where applicable.*

A restructure such as this takes time to negotiate, agree pricing, the share of any upside, financial and other covenants, obtain credit approval etc. It will not occur overnight and it is important that timing and documentation requirements are considered when determining likely outcomes.

The newco business operated under a licence arrangement. Shortly before concluding new banking arrangements for the residual viable part of the business the licensor alleged that the newco business was insolvent, presumably in an attempt to buy back the business cheaply. Under the terms of the license agreement, the license could be withdrawn in such circumstances – which would have been a fatal blow to the business.

The business was paying its debts as they fell due. However at that stage it was reliant upon a substantial overdraft facility which was in default. As part of the restructure plan almost all of the debt was switched into a three year capital note. Once the overdraft was switched into a capital note it was felt that the business was solvent on a cash flow and balance sheet test. The licensor ultimately accepted that – albeit after a few frank discussions.

2.4 Ongoing Monitoring

Monitoring on an ongoing basis for the group consists of encouraging strong governance with monthly board meetings and tight business disciplines. In addition key business drivers are reported weekly and are used as an early warning system. Finally there are regular meetings with the bank to ensure that are fully briefed as to progress.

The group has come a long way and is now producing strong EBITDA. Like all restructurings there have been a few wobbles along the way, but that is to be expected in situations such as these. The key here is to ensure that good processes and systems are in place to enable early identification of these issues and to take immediate steps to rectify them.

- *Attendance at board on an ongoing basis is another risk area for advisors. Once again, maintaining independence and no direct involvement in decision making are essential.*
- *Any involvement at board such meetings should be clearly depicted as that of an independent observer to ensure advisors' actions are not seen as those of directors.*

2.5 Development of Exit Strategy

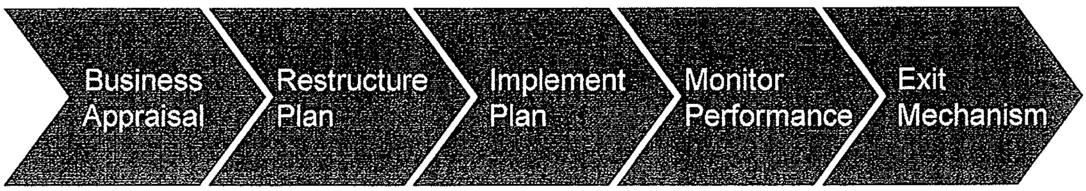
The group is still very much focussed on growing the business. However at some point we expect that the business will be sold or refinanced and will generate substantially more than would have been the case had the bank enforced or the group been sold as a going concern. One of the issues currently being considered is the timing and method of such an exit.

- *Again in any ongoing role to maintain independence an advisor must consider the outcome for all stakeholders of the entity.*

3. Conclusion

3.1 Opting for a restructuring or "work-out"

Outlined below is a high level overview of a restructure process:



1) Conduct a business appraisal to establish the position of the business
2) Development of a restructure plan
3) Implement the restructure plan
4) Monitor performance
5) Develop an exit mechanism

When successful, the eventual value to stakeholders from a restructuring or "work-out" can be substantially higher than a formal insolvency process or immediate sale. However, restructuring a business can be complicated, time consuming and stressful, therefore in determining to proceed the following factors are essential:

- A viable core business
- Clear stakeholder communication processes
- Reliable financial and industry data
- Strong management – i.e. the right people in the right positions
- Focus directed on cash flow and adding value

3.2 Overview of risks as an advisor in a restructure or "work-out" situation

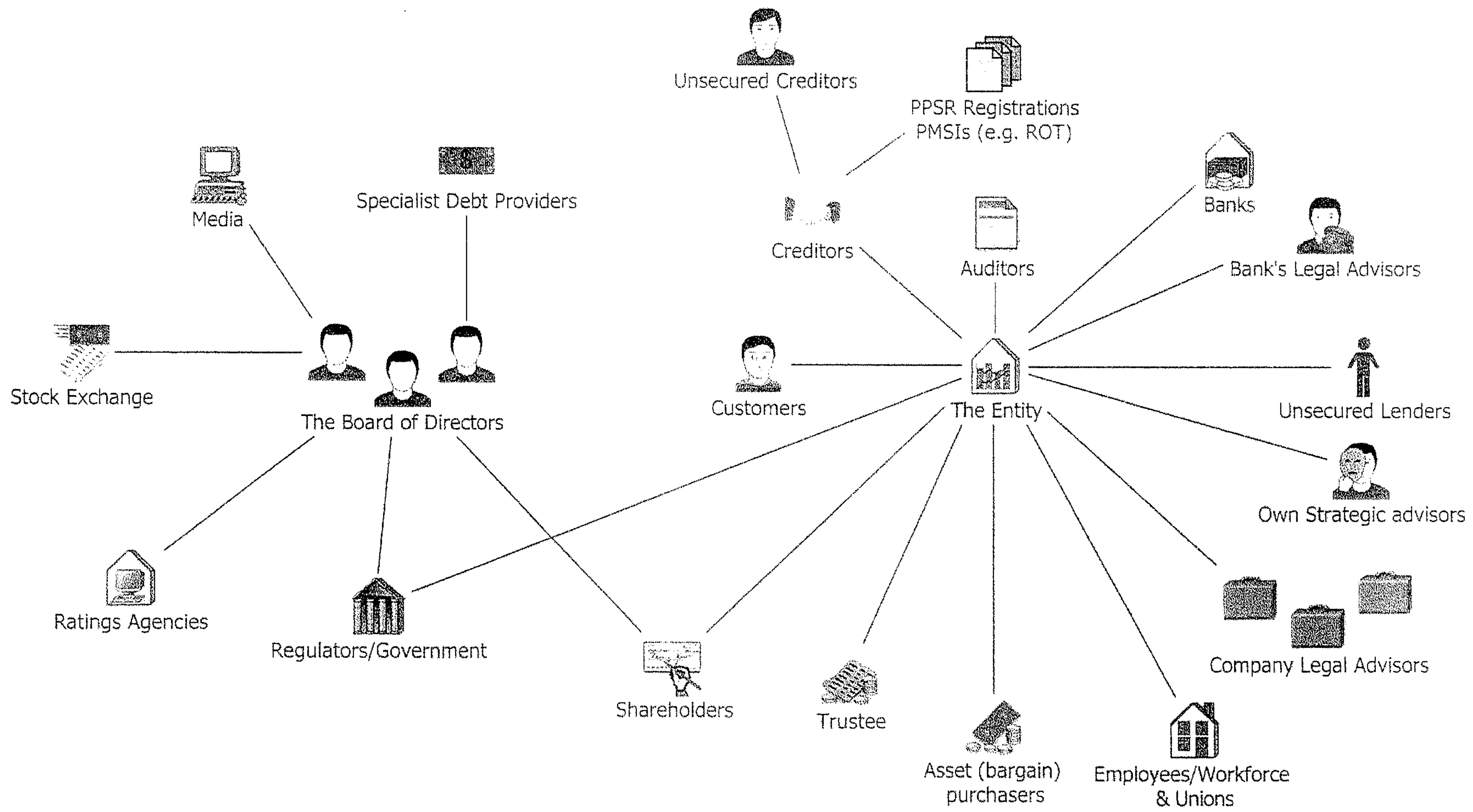
Due to the time component and complexity of a restructure, advisors are likely to experience greater exposure to the risk of allegations of shadow directorship. To minimise this risk, advisors must ensure that, not only is their role and its limitations clearly documented prior to commencing each stage of the restructure process, but also that their actions and methods of reporting and recommending actions are consistent with the entity's board and management retaining control and responsibility for key decisions. Examples of key terms/actions are:

- Engagement terms
  - Engaging party should be entity concerned
  - Standard indemnities
  - Limitation of liability
  - Scope of role, and any alteration thereof throughout the process

- Practical actions
  - Avoidance of situations which imply pressures placed upon management/board by the advisor
  - Ensuring all stakeholders' needs considered
  - Ensuring reality of role is consistent with scope of engagement
  - Ensuring that management/board are regularly reminded of their duties and ultimate responsibility in opting for particular actions

Advisors who fail to adequately state or undertake their role in an independent and non-decision-making manner during a restructure process run a material risk of incurring personal liability should the process be unsuccessful and where, as a consequence, losses are incurred by stakeholders.

Parties associated with entity in financial difficulties



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