

# Fiduciary Duties in Turbulent Times

“Bear Stearns’ balance sheet, liquidity, and capital remain strong....Our liquidity position has not changed at all, our balance sheet has not changed at all...”

—Alan Schwartz,  
CEO of Bear Stearns  
March 12, 2008  
appearance on CNBC

“In a shocking deal reached on Sunday [March 16, 2008] to save Bear Stearns, JP-Morgan Chase agreed to pay a mere \$2 per share to buy all of Bear – less than one-tenth the firm’s market price on Friday [March 14, 2008].”

—The New York Times, March 17, 2008

“We have a long track record of pulling together when times are tough...[w]e are on the right track to put these last two quarters behind us.”

—Richard Fuld,  
CEO of Lehman Brothers, September 10, 2008 conference call with analysts

“Lehman Brothers Holdings, Inc., announced today that it intends to file a petition under Chapter 11 of the United States Bankruptcy Code....”

—Lehman Brothers press release, September 15, 2008



### By Richard De Rose

In her classic 1969 book, *On Death and Dying*, Dr. Elisabeth Kübler-Ross described five stages through which an individual transitions when confronted with a prognosis of terminal illness. The first of the stages she identified was “denial”—the earnestly held belief that “this can’t be happening to me; the doctors must be wrong.” If asked, any experienced restructuring professional can quickly catalog at least a dozen cases in which he or she has been involved where corporate managements have failed to acknowledge a growing financial problem. The performance excuses are legion and generally run along the lines of “we will have improved results next quarter” or “despite our disappointing results, we are very excited about our prospects for the future.”

Human nature often compels us to ignore the inevitable:

- Waiting too long to address the issues, hoping things will get better.

- Waiting too long to address the issues, rationalizing that openly acknowledging distressed conditions will “sink the company.”

- Over-stretching waning liquidity options to make payments and avoid defaults (“borrowing from Peter to pay Paul”).

- Effecting short-sighted deals or taking short-sighted actions as band aids.

Unfortunately, as the meltdowns at Bear Stearns and Lehman Brothers have painfully illustrated, a company’s failure to timely recognize that it is operating with impaired liquidity and to appreciate the severity of the “distress” can prove calamitous. In

the more congenial banking environment of years gone by, a company’s failure to meet a maintenance or other covenant would have precipitated a negotiation with the company’s lenders with a view towards waiver of the default and/or amendment of the underlying loan documentation. In today’s credit-constrained world, such a technical default may begin a potentially irreversible slide into bankruptcy.

In such situations, directors of financially troubled companies are likely to find themselves caught in the middle of a zero-sum game between “out-of-the-money” stockholders who are willing to have the company “bet the ranch” to salvage their investment and creditors who are loath to see their potential recoveries jeopardized through quixotic endeavors to “maximize” stockholder value. Needless to say, faced with the prospect of financial loss, both stockholders and creditors will be quick to litigate if a course of action chosen by the board of directors threatens to impair their respective interests. As a consequence, directors of all but the healthiest of companies need to understand the contour of their fiduciary duties in the context of financial distress.

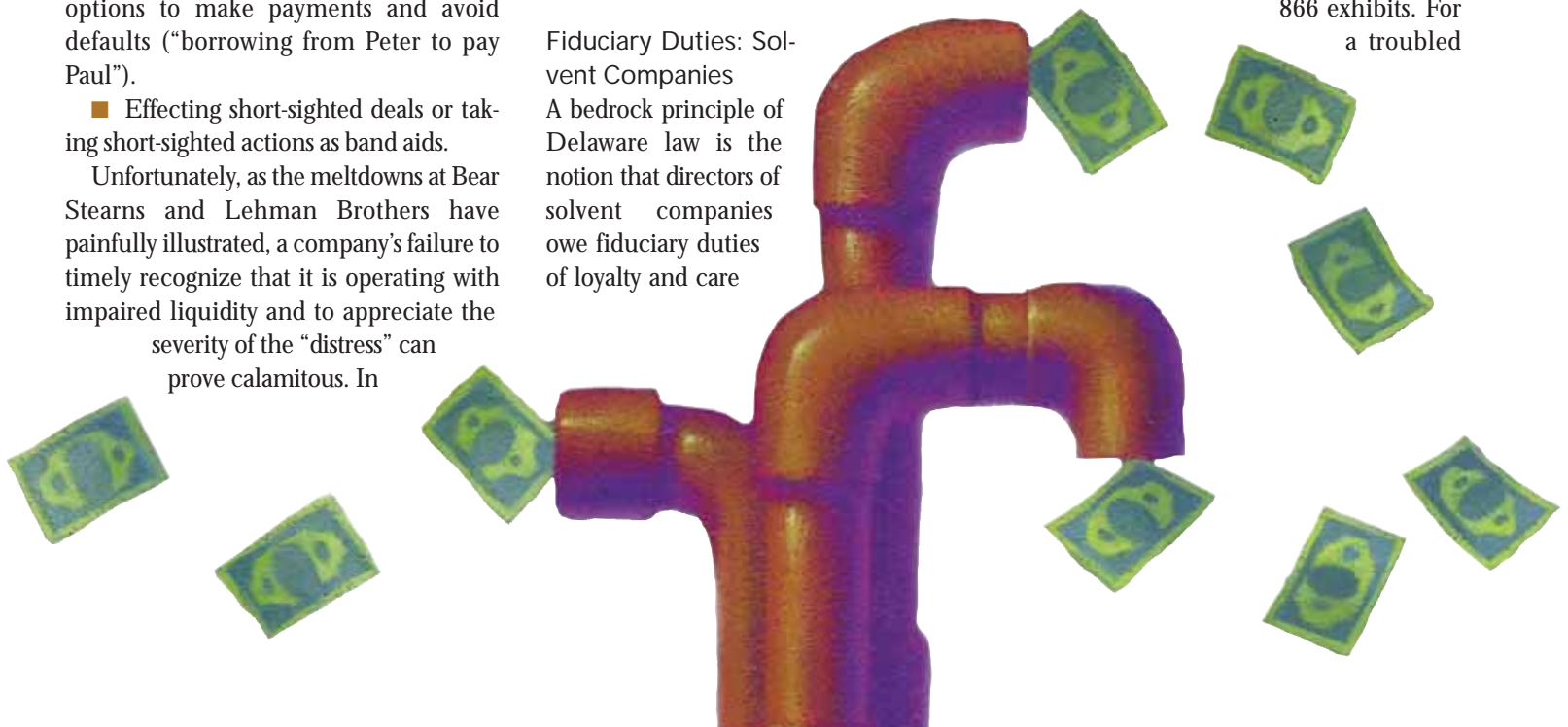
#### Fiduciary Duties: Solvent Companies

A bedrock principle of Delaware law is the notion that directors of solvent companies owe fiduciary duties of loyalty and care

to the corporation and its stockholders.

In contrast, it is equally well established that fiduciary duties are not owed to creditors of a solvent company. Such creditors are presumed to be able to protect themselves contractually or through creditors’ rights laws. Similarly, the directors of a solvent company do not owe fiduciary duties to holders of the shares of a Delaware corporation’s preferred stock. Again, such holders are deemed able to protect themselves through the negotiated provisions of the certificate of designation and/or the stock purchase agreement by which they became holders.

Beyond these seemingly simple principles, the analysis becomes more complicated and revolves around whether the company is, in fact, solvent or not. Ironically, while a company’s solvency can change (literally) from one day to the next (as the implosions at Bear Stearns and Lehman Brothers vividly demonstrate), the need to prove or disprove solvency “after the fact” can result in lengthy and expensive litigation. Indeed, the issue of insolvency in the Iridium bankruptcy case took 50 days of trial and testimony, 52 witnesses, seven experts and 866 exhibits. For a troubled



company, professional financial advice in the form of a solvency opinion may be needed to assess solvency at any given point in time.

**Fiduciary Duties: Insolvent Companies**  
A corporation is deemed insolvent under Delaware law when (i) there is a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof or (ii) it is unable to pay its debts as they come due. The test is forward-looking: it is not enough for a corporation to meet its current obligations; it must be able to meet its future obligations as well. The fiduciary analysis focuses on the board's belief at the time and whether that belief was reasonable.

The state of insolvency, in and of itself, does not change the focus of directors' duties, which is the corporation itself. In *Nelson v. Emerson*, the Delaware Chancery Court stated that: "It is settled Delaware law that an insolvent company is not required to turn off the lights and liquidate when that company's directors believe that continuing operations will maximize the value of the company."

At the same time, however, the Delaware Supreme Court also made it clear in *NACEPF v. Gheewalla* that when a corporation is insolvent, creditors have standing to assert derivative (but not direct) claims against directors for breach of their fiduciary duties. The logical underpinning of this conclusion is that, upon insolvency, creditors take the place of stockholders as the principal constituency injured by any fiduciary breaches that diminish the value of the corporation.

Fortunately, in balancing conflicting stockholder and creditor interests, directors remain entitled to the "business judgment rule" presumption that they are acting independently, in good faith and with due care. Insolvency notwithstanding, the rule continues to protect directors so long as

they act on an informed basis, in good faith and in the best interests of the corporation.

However, because creditors of an insolvent company can bring derivative actions for breach of fiduciary duty, directors' actions, even though protected by the business judgment rule, can be subject to

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**"You're traveling through another dimension—a dimension not only of sight and sound but of mind. A journey into a wondrous land whose boundaries are that of imagination. That's a signpost up ahead. Your next stop: The Twilight Zone."**

*Rod Serling, narrator, The Twilight Zone*

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litigation. Accordingly, directors need to take special care in distressed situations to ensure that they have built a record of staying informed and taking actions that best serve the entire enterprise rather than any single group of stakeholders. Such care is especially warranted when a controlling stockholder is a principal party to a transaction such as an exchange offer or a down-round financing. In such situations, the more exacting "entire fairness" standard of review may be applicable, and a board may be well advised to secure both a fairness opinion and a solvency opinion from an independent financial advisor to buttress its decision-making process.

#### Duties in the Zone of Insolvency

Between the relative bright lines of solvency and insolvency lies the oft-referenced "zone of insolvency," where the company is on the brink of becoming insolvent. The concept was first introduced into Delaware jurisprudence in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, a case in which the Delaware Chancery Court articulated the possible conflicts that might arise in the context of

impending insolvency: "[I]n the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corpora-

tion) would make if given the opportunity to act."

Until relatively recently, *Credit Lyonnais* was cited for the proposition that directors of a corporation in the zone of insolvency owe fiduciary duties to both stockholders and creditors. In more recent cases, however, the Delaware courts have called this view into question. In *Production Resources Group, LLC v. NCT Group, Inc.*, the Chancery Court observed that *Credit Lyonnais* was intended to operate as a "shield" against stockholder suits (alleging that directors had acted to protect creditors) rather than as a "sword" for creditors to force directors to favor creditor interests.

Similarly, in *Gheewalla*, the Delaware Supreme Court affirmed that fiduciary duties do not shift to creditors: "[W]hen a solvent corporation is navigating in the zone of insolvency, the focus for...directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its [stockholders] by exercising their business judgment in the best interests of the corporation for the benefit of its [stockholder] owners."

It is generally difficult to ascertain when a company enters the zone of insolvency.

While the tests for insolvency are easy to state, their application can be difficult - especially where there are unknown or contingent liabilities.

Although the Delaware courts have not defined the boundaries of the “zone of insolvency,” at least one case, *Adlerstein v. Wertheimer*, set forth several factors to be considered:

- Was the company facing a liquidity crisis?
- Was there a dearth of trade credit?
- Was there insufficient cash to meet payrolls?
- Did the company’s auditors refuse to issue a going concern opinion?

Other “signposts” demarcating the zone of insolvency might include the fact that a company:

- has been financing losses through asset sales or short-term borrowings;

- collateralizing unencumbered assets to raise cash;

- continued declaration of dividends;
- sales of assets for arguably less than “reasonably equivalent value;”

- failure to consider a sale of the company; or

- pursuing financing alternatives without making contingency plans for a bankruptcy filing.

Often, companies struggling in the zone of insolvency are forced to turn to controlling stockholders for liquidity through Private Investments in Public Equity Securities, (PIPEs) and down-round financings. These types of transactions are frequent targets of litigation and should be carefully reviewed by a committee of independent directors with the assistance of highly qualified advisors.

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**In distressed situations, directors need to take special care to ensure that they have built a record of staying informed and taking actions that best serve the entire enterprise rather than any single group of stakeholders.**

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- is in an industry or sector that is experiencing a downturn;

- is emphasizing short-term profits over generating positive cash flow;

- is extending its accounts payable over lengthening periods of time; or

- is taking aggressive accounting positions.

When a company is operating within the zone of insolvency, many otherwise ordinary decisions by the board of directors will be subject to increased scrutiny by stakeholder constituencies and, potentially, by the courts:

- failing to reduce costs;

### Deepening Insolvency

Over the years, some federal district and bankruptcy courts have suggested that the courts of certain states (e.g., Pennsylvania) would recognize a cause of action for “deepening insolvency.” Under this theory, a plaintiff could claim that a decision to borrow additional funds when the corporation was insolvent (in the hope such funds would help the company through a crisis) caused the entity to become more insolvent and thus less able to pay creditors’ claims.

In response to these cases, the Delaware courts have clarified that Delaware law does not recognize an independent cause

of action for deepening insolvency. In *Trenwick America Litigation Trust v. Ernst & Young, LLP*, the Court indicated that directors do not breach their fiduciary duties by pursuing a strategy that, if successful, would benefit the corporation, even if it turns out that such strategy ultimately fails. So long as the decision-making process is proper and undertaken in good faith, the board is permitted to pursue strategies that it believes will maximize the value of the company. In this regard, incurring additional debt in the face of insolvency does not, by itself, establish bad faith or disloyalty.

Subsequent to *Trenwick*, the U.S. Bankruptcy Court for the District of Delaware held that, although it is not an independent cause of action, deepening insolvency may be used to assess damages for breach of fiduciary duty.

### Caremark Duties

Oversight of a large enterprise is challenging in the best of times. During times of distress, the challenge is compounded when the board must also address complex restructuring issues

Under Delaware law, directors have a duty to implement an oversight system that permits the board to monitor the company’s business and become informed of potential material risks. In the current environment, breaches of the *Caremark* duty are likely to be alleged in lawsuits against directors of distressed companies. Claimants will argue that the directors breached their fiduciary duties by failing to implement appropriate oversight systems or by failing to heed “red flag” warnings of risk.

Fortunately, the Delaware Supreme Court has emphasized that a showing of bad faith is a necessary condition to director oversight liability under *Caremark*. In *Stone v. Ritter*, the Court noted that: “[T]o establish oversight liability, there must be a showing either that the directors knew they

were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities, such as by failing to act in the face of a known duty to act.”

Based on the *Stone* decision, the Delaware Court of Chancery recently dismissed allegations that the directors of Citigroup breached their fiduciary duties by ignoring numerous “red flags” and by failing to properly monitor the company’s exposure to the subprime mortgage crisis. In dismissing the claims, the Court reaffirmed that the business judgment rule applied in the context of directors’ duty of oversight of business risks. The mere fact that a company takes on business risk and suffers substantial losses does not establish bad faith. To state a claim for director oversight liability, a plaintiff must plead particularized facts proving that directors acted in bad faith.

While Citigroup makes it clear that the Delaware state courts will not second guess directors in assessing business risks, directors should, nevertheless, remain vigilant in monitoring those risks. A bankruptcy court may have its own perspective on the application of the relevant Delaware law. For example, in *Bridgeport Holdings Inc. Liquidating Trust v. Boyer*, the bankruptcy court refused to dismiss a breach of fiduciary duty claim against directors who approved the sale of a financially distressed company’s assets on the eve of bankruptcy. The court concluded that sufficient facts were alleged to support a claim that the board acted in bad faith and breached their duty of loyalty by failing to adequately monitor the sale process.

#### Capital Structure and Risk

Given the velocity with which companies previously regarded as sound have been rendered insolvent, boards are well-advised to continuously focus on capital structure and its implications for the company’s

short-term liquidity risk and its long-term solvency risk.

It is generally well known that financing a business through borrowing is less costly than raising an equivalent amount of equity financing. This is because, among other things:

- lenders require a lower rate of return than common equity holders (owing to their priority in the capital structure and the frequent presence of collateral),
- interest on debt is deductible for tax purposes, and
- the issuance costs for debt securities are less than for equity securities.

In addition, one of the principal motivations for using financial leverage is to magnify stockholders’ return under favorable economic conditions. Because debt generally carries a fixed interest charge, the cost of financing can be limited. If the business can earn a return on its assets in excess of the cost of debt (interest), it makes an overall profit. However, the use of incremental amounts of debt increases the risk of financial distress due to the requirement to pay interest regardless of the cash flow of the business.

Thus, capital structure choice invariably involves a classic trade-off between risk and return. Incurring additional debt raises the risk profile of the firm’s earnings stream, but often leads to a higher expected rate of return. The higher risk associated with greater debt, in turn, tends to lower the company stock’s price. But, at the same time, the higher expected rate of return makes the stock more attractive to investors. The optimal capital structure is the one that strikes an appropriate balance between risk and return to achieve our ultimate goal of maximizing the stock price.

In striking that balance, the board needs to be actively involved in assessing whether the company’s balance sheet is strong enough to withstand a sharp and/or prolonged downturn. Is the company trying to

## Assessing the Balance Between Debt, Equity

Among the various considerations that a board should consider in determining the appropriate balance between debt and equity in a company’s capital structure are the following:

**Business Risk** If the nature of a firm’s business results in a revenue stream that is inherently volatile and, because of the nature of the business, the firm is burdened with high fixed operating expenses, e.g., airlines, the addition of incremental debt to the firm’s capital structure should be more carefully considered.

**Tax Position** If a substantial portion of a firm’s income is already sheltered from taxes through accelerated depreciation or tax loss carry-forwards, the tax shield afforded by debt financing will not be as advantageous as it would be to a firm with a higher effective tax rate.

**Financial Flexibility** Does the company have the ability to raise capital on reasonable terms under adverse conditions?

**Managerial Competence** Does management have a successful track record in operating through severely adverse market conditions?

**Concentration** Is a large portion of the company’s business subject to concentration risk in terms of customers, geography or seasonality?

**Industry leverage** Is the company operating with a level of leverage that materially exceeds that of its industry competitors?

**Life cycle** Is the company still growing or has it achieved a maturity where free cash flow is predictable and stable?

**Competition** Does the company enjoy a defensible niche in its industry or face intense competition from larger, better-capitalized companies? —R.D.

do too much with too little?

Undercapitalization places a company on the edge of failure; a slight slip in operations or misjudgment in strategy can result in a company that is foundering and has little to resuscitate itself.

### Solvency Risk

Despite striking examples like Bear Stearns and Lehman Brothers, businesses do not typically become insolvent overnight. Rather, most businesses that ultimately experience financial difficulties will pass through several transitional stages on the way to insolvency. During the incubation period, one or more serious problems may be developing quietly without being recognized by outsiders or, in some

cases, even by management or the board. The aim of long-term solvency analysis is to highlight early on that a business is on the road to financial distress. In this regard, the board, with the aid of an experienced financial advisor, should ensure that an “early warning system” is in place to monitor the key indicators of the company’s performance, with prompt reporting to the board of material variances and their potential consequences. Some of the obvious symptoms of a developing solvency crisis include:

- Declining sales
- Declining gross and operating margins
- Increasing SG&A expense
- Declining net profits and lower return

on invested capital

- Overexpansion without adequate financing facilities
- Weakening cash position
- Significant pension underfunding
- Overexpansion in fixed assets
- Excessive funded debt and fixed liabilities

Perhaps even more important than the analysis of long-term solvency risk is the analysis of short-term liquidity risk. Firms must survive in the short-term if they are to survive in the long-term. The global financial crisis of the past 18 months has highlighted the importance and danger of liquidity risk, i.e., the risk that a company’s near-term ability to generate cash will be insufficient to service working capital

## A CFO’s Perspective

### By Cynthia Jamison

Access to the capital markets is one of several critical areas, which CFOs must understand, assess and intelligently navigate. The CFO must understand the current capital structure, accurately project liquidity needs, assess the best instrument to use to introduce new funds into the

capital structure and guide potential equity or debt investors to appropriately evaluate the risk they assume by investing in the proposed funding.

In dealing with investors, the CFO faces a special challenge: They must report financial results under GAAP accounting, but augment that information with insight into operational business results and opportunities. This requires a blend of respect for the required reporting structure, creativity in expanding upon that to capture any elements where “reality” may not be completely reflected and, finally, communication skills that illuminate—rather than cloud—the differences between the two.

#### The EBITDA Quandary

Many companies use EBITDA as one measurement of operating performance because it captures earnings before they are distorted by financing consequences

(interest charges), statutory charges (income taxes) and/or accounting non-cash charges required to be reflected in the P&L (depreciation and amortization). To many, this is the “purest” reflection of the actual health of the business, free of distortions. The problem? EBITDA is not recognized as a GAAP measure. In fact, regulatory requirements actively discourage the use of this measure. Companies using any kind of an EBITDA measure must show a thorough reconciliation from EBITDA to GAAP reported income and run a higher risk of regulatory review as a consequence. This discourages use of a very helpful and insightful measurement that would give potential investors a better insight into the historical operating performance of the company.

There is no doubt that simply (and only) reporting EBITDA would be misleading. In fact, those elements of non-operational risk reflected in GAAP net



needs and debt-service obligations. The implosions at Bear Stearns and Lehman Brothers serve as loud warnings that boards need to be attentive to their company's liquidity needs and risks, and should ensure that management has implemented appropriate stress testing procedures to measure the effects of potential liquidity shocks both from operations and from disruptions in the financial markets. At a minimum, adequate preparation involves establishing a monitoring system, identifying liquidity alternatives and developing contingency plans.

A business entity can have a desirable excess of assets over liabilities and an acceptable earnings record, but still be in dire need of cash. This problem occurs

because assets are not liquid enough and the necessary capital is tied up in receivables and inventory. Often such a business is not able to obtain funds to meet maturing and overdue obligations through customary channels. Similarly, a company that is performing well can become undercapitalized as it experiences rapid, unplanned growth. Such growth limits management's ability to control its capital position, as it may be unable to meet the new levels of demand. Increased growth will heighten inventory and accounts receivable levels, which, in turn, requires additional means of financing either through borrowings or the use of other current assets.

Given that the least expensive source of

cash is effective working capital management, in the current environment, cash flow management needs to be a strategic board priority. Poor management of working capital allows for the slow payment of receivables which results in needed cash being left outside the company. Likewise, an undisciplined management of inventory creates unnecessarily high inventory levels (and the additional risk of future obsolescence) and less cash available for other parts of the business. Effective working capital management frees up cash, which can be used to continue to fund ongoing business operations as well as strategic initiatives that will benefit the company when the economy recovers.

To be effective, management and the

income are pertinent facts for investors to see and understand. High interest charges reflect a highly levered business, which increases risk. Taxes must be paid if there is reported income and so should not be ignored completely although the complexity of tax accounting adds confusion for many. And depreciation and amortization paint a picture of "usage" against items that have a finite life. Once depleted, the balance sheet may reflect a different level of health. Therefore, the "complete" picture must be preserved and reported, of course.

It is strange, though, that our regulatory requirements don't encourage reporting additional insights and viewpoints into the business. While potentially confusing to some (the stated reasoning behind the rigidity) it would surely add illumination for others. One could argue, in today's more complex investing environment of hybrid securities, diffused risk and off-bal-

ance sheet line items that those who cannot completely comprehend all aspects of financial reporting may want to think twice about being in the market at all.

There is a second aspect to this distortion of reported risk for investors as well. Any good accountant will tell you that within the GAAP reported figures there are numerous areas where judgments and estimates must be used. It is important—even critical—that investors have more insight into the approaches taken to make these estimates. Assumptions can vary widely and a set of "conservative" financial statements prepared using wildly "aggressive estimates" can be deceptively appealing to risk-adverse investors. Case in point: financial institutions showed more health than they actually held because their assessment of the liability they held as a result of shared risk (through derivatives) turned out to be pitifully off the mark.

The point is this: GAAP accounting—

that esteemed, respected foundational element of regulatory filings—is not infallible. Certain characteristics of it may make sense in one arena (accounting properly) but distort results—either positively or negatively—in another arena (investment evaluation). Investors beware: simply looking at reported results will not give you a complete picture. We have all learned a painful lesson in the past 18 months regarding the need for a complete and thorough understanding of investment risk, and this requires detailed financial and operational analysis beyond GAAP accounting. Despite the challenges of reduced staffs in our current era of "lean leadership," directors and CFOs of companies accessing the capital markets must do their homework, whether making an investment or bringing on investors.

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Cynthia Jamison is national director of CFO Services, Tatum LLC.

board need to take early action. Some of the classic warning signs that should trigger close scrutiny of a company's liquidity include:

- Unusual/inexplicable increases in accounts receivable
- Credit rating downgrades
- Lengthening days payable
- Upward trend in other liabilities
- Negative cash flow from operations
- Deferral of capital expenditures
- Liquidating current assets such as marketable securities
- Inability to make interest payments on public or private debt
- Covenant defaults under long-term credit agreements

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**Distressed situations are extremely complicated and it is important for directors to consult with experts. Under Delaware law, directors are protected in performing their duties in their good faith reliance on the opinions and reports of outside experts.**

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### Practical Considerations

As a result of the recent recession, it is likely that many companies will continue to operate within or near the boundaries of the zone of insolvency for at least the next 12 months. Accordingly, directors are well advised to review their company's near-term (12-24 months) business plan, with a specific focus on liquidity and capital requirements and sources. The plan should be "stress tested" against possible downside scenarios and the key assumptions regarding operating cash flow, such as new contracts, new stores, etc. should be debated with management. If appropriate, a revised plan should be developed.

In collaboration with management, the board should assess whether the company's cash management system is adequate-

ly staffed and appropriately controlled. Moreover, the management should identify and evaluate any risks to company's ability to access (i) short-term liquidity resources, including cash temporarily invested with third parties, availability under revolving credit facilities and normal deferred payment terms for goods and services; and (ii) longer-term capital resources, including free cash flow and capital markets for debt and equity.

The company's debt and other material agreements should be reviewed from the perspective of the cash flows in the company's business plan and downside scenarios to evaluate covenant compliance and potential defaults and cross defaults. The

management should identify liabilities that the company will not be able to pay as they come due in the ordinary course of business and should consider early renegotiation of covenants and other terms that are likely to be violated.


Importantly, the management and board should develop contingency plans for accessing liquidity and capital beyond traditional sources. Steps that might be considered include (i) drawing on existing borrowing capacity and holding cash, (ii) implementing cost reduction and other cash conservation measures, including suspension of dividends, and (iii) identifying and valuing unencumbered, non-core assets that could be sold to raise cash.

In these times, board deliberations are critical and will be thoroughly scruti-

nized in future litigation. It is therefore extremely important that the record reflect that directors devoted more time and attention to the company's affairs than would have been required if the company were financially healthy. Boards should remember to:

- Become informed of all material information reasonably available
- Be fully engaged in the process
- Seek the advice of financial and legal experts
- Establish and maintain an appropriate process and document it accurately
- Document the board's good faith exercise of its business judgment and its acknowledgement of the fact that the company is experiencing financial difficulties.

Within the zone of insolvency, directors should proceed with the objective of preserving and enhancing the entire corporate enterprise rather than acting for the benefit of any single group.

Distressed situations are extremely complicated and it is important for directors to consult with experts. Under Delaware law, directors are protected in performing their duties in their good faith reliance on the opinions and reports of outside experts. It is not uncommon for management to resist outside assistance without prompting from the board or other stakeholders. The board must make an unemotional assessment of management's ability to deal with issues facing the company and seek appropriate assistance from outside sources. Timely decisions on these issues can help build credibility with stakeholders. 



Richard De Rose is managing director of Houllihan Lokey in New York. He can be contacted at [rderose@HL.com](mailto:rderose@HL.com)

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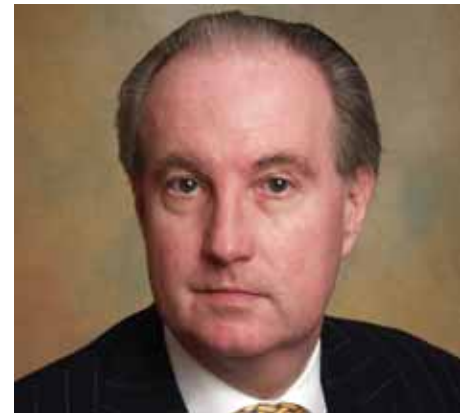
# Navigating Post-Crisis Dynamics

Directors duty at the brink of insolvency, the importance of liquidity, the shortfalls of GAAP

The capital markets presented public company board directors with a variety of vexing issues in 2009. Most importantly, it underscored the need for board directors to have a much better understanding of a company's liquidity and how the risk profile—which was developed by models that were range bound by historical scenarios—would behave under extraordinary conditions as

and Lehman Brothers illustrate, companies with impaired liquidity may not always appreciate the severity of their distress despite the presence of expertise and experience inside the management team. Further testing of assumptions and healthy debate, which encourages a diversity of opinion is required now, or else the risk again is that by the time the true risks are recognized the

Accepted Accounting Principals (GAAP) set since 1973 by the Financial Accounting Standards Board (FASB). “In my experience, the bigger the company the more likely they are not managing on a ‘cash flow’ basis. By focusing on the P&L and/or balance sheet, some items require GAAP presentation that may not completely portray the risk element from an operational



From left to right: Tonia Pankopf, Cynthia Jamison, Richard De Rose

came to pass. For that to happen, it has now become abundantly clear that directors need to engage in even more robust and candid discussions about selecting the appropriate capital structure for the company they serve. Among the many challenges faced last year, it was the derivatives crisis that showed in clear catastrophic fashion just how quickly capital structures, which had worked well for companies throughout the decade, can vanish at the least opportune time. The financial crisis cemented the need for the board's engaging in real world and expertise driven “what-if” and “worst-case” scenarios on risks to solvency and liquidity on an ongoing basis.

As the rapid meltdowns at Bear Stearns

market has discovered it as well, and has shuttered all available solutions.

“There are probably dozens of stories of situations where if somebody had just said, ‘I think we’ve got a problem here,’ insolvency could have been avoided,” observed Houlihan Lokey's Richard De Rose, who together with Cynthia Jamison of Tatum LLC, the executive services and consulting firm focused on the office of the CFO, facilitated a recent Peer Exchange on Capital Markets at Directorship's New York office.

Jamison, who in addition to serving as the national director of CFO Services at Tatum is a director at Tractor Supply and B&G Foods, points out that sometimes problems can stem from Generally

perspective. Derivatives are a perfect example of this.”

Should corporations have chief risk officers and how should boards be educated?

“You cannot have a conversation about risk without strategy,” said Jamison. “If you're going to have a conversation about risk it must be about strategy and one person needs to own that.”

Leslie Rahl, founder, Capital Market Risk Advisors, suggested that the “next great front” for financial firms and banks, in particular, “is for boards to figure out what its risk appetite and risk attitude is and how to communicate that to management.”

Directors need to do their own independent assessments, said Tonia Pankopf,

a veteran research analyst and investment manager, and not always rely totally on company or management information “When you make an investment you talk to competitors, suppliers and customers. I review the materials presented to the board but also consult with other reliable sources of information when possible,” says Pankopf, who is managing partner of Pareto Advisors and a director of TICC Capital. “I may end up hiring a third party but there’s work I do on my own to be informed about the company and the industry.”

How should directors carry out their fiduciary responsibilities, asked Jeffrey M. Cunningham, the chairman, CEO, and editorial director of Directorship. De Rose noted that directors of solvent companies owe fiduciary duties of loyalty and care to the corporation and its stockholders. And when it comes to being held accountable for their decisions, “as long as you [the



Jeffrey S. Sherman and Leslie Rahl

director] listened to advisers, and looked at every alternative you’d be protected by the business judgment role,” he said.

“Ask the real simple questions: what could go wrong?” suggested Rahl.

Noting that she serves exclusively on non-financial services company boards, Jamison said, “We ask management what keeps you up at night and if that happens, what is your tactical plan? When and if you march down that path who would you call? Who would you fire? The answers tend to

get really crisp.” As for the CFO, Jamison says, “The CFO needs a strong defense. You need to have everything documented and to have considered all sorts of scenarios. The CFO really has to build the book.”

Added Jeffrey S. Sherman, senior vice president and general counsel at BD (Becton, Dickinson and Company), a medical technology company: “One question that should always be asked of management: is there anything you haven’t told the board that they should know?”

What’s the biggest risk in capital markets?

“I don’t believe we’re out of the crisis quite yet and that we’ve got another two to three years,” cautioned David Meachin, chairman and CEO of Cross Border Enterprises, an investment bank, and a director at Metha Energy Solutions and BTM Corp. Companies “continue to have a tough time getting the money that they need to borrow without risk,” said Sherman.

Pankopf replied that it’s the issue of liquidity and balancing the capital needs to fund ongoing operations and new investments” that is the greatest challenge. “Some companies that have sufficient liquidity can be opportunistic and use that liquidity to fund new areas of growth,” she said.

Meachin agreed that liquidity is and will be critical for the next two to three years: “The outside environment will continue to be a challenge and the board needs to be involved...The world will change again and you need to keep your eyes wide open.”

In the current environment, De Rose said, “directors need to be actively involved. Although your responsibility is to supervise rather than to micromanage, in order to supervise adequately, a director needs to have a thorough understanding of all aspects of the business and the challenges and risks associated with that business. **D**”

## Participants

**Richard De Rose**  
Managing director  
Houlihan Lokey

**Cynthia Jamison,**  
National director of CFO Services  
Tatum LLC  
Director, Tractor Supply, B&G Foods

**David Meachin**  
Chairman and CEO, Cross Border Enterprises; director, Metha Energy Solutions, BTM Corp.

**Tonia Pankopf**  
Managing partner, Pareto Advisors  
Director, TICC Capital

**Leslie Rahl**  
Founder, Capital Market Risk Advisors  
Director, CIBC

**Jeffrey S. Sherman**  
Senior vice president and general counsel, BD (Becton, Dickinson and Company)

**Jeffrey M. Cunningham**  
Chairman, CEO and editorial director  
Directorship

**Christopher Y. Clark**  
President and publisher, Directorship

**Steve Kalan**  
Senior vice president business development/associate publisher,  
Directorship

**Judy Warner**  
Chief content officer,  
Directorship