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BEST-PRACTICE GUIDELINE

# TURNAROUNDS

Authors: David Bryan and Alan Tilley, Bryan, Mansell & Tilley LLP  
Stephen Cork and Katie Moffitt, Cork Gully LLP

**May 2011 Issue 53**



# GUIDELINE

## INTRODUCTION

### EVOLUTION OF TURNAROUND PRACTICE

The legislation governing the protection of creditor and debtor interests in corporate distress is still evolving. It varies from jurisdiction to jurisdiction and this impacts on turnaround and restructuring practice in international cases; an increasing issue in a global economy.

Different legislation in different countries is also impacting the evolution of the turnaround process as professionals move from country to country and challenge accepted local practice. In the UK, the growth in US investment banks in London has led to the import of concepts rooted in the US bankruptcy process where it has been more appropriate to give failed entrepreneurial activity a second chance.

The 1979 US Bankruptcy Code facilitated the process known as 'debtor in possession'. Management was given the chance to reorganise the business and restructure the balance sheet under court supervision while managing day-to-day operations protected from creditors by an automatic stay. During the 1980s a new group of professionals emerged in the US, skilled in helping management to navigate through the complexities of managing in this 'zone of insolvency' (see Scope and definition of a turnaround). These became known as turnaround managers and the role of chief restructuring officer evolved later to describe this activity.

### TURNAROUND MANAGERS AND CHIEF RESTRUCTURING OFFICERS

In the UK, change managers or 'company doctors' took over ailing businesses as chief executives and were statutory directors. But as companies slimmed down and flattened their management structure a need developed for executives with specific skill sets to work on an interim basis to drive change. This could be change by a specific project in a solvent company or, where it involved a major redirection of effort to prevent decline becoming corporate failure, change in the zone of insolvency (see page 5) to prevent an insolvency filing.

Following the Insolvency Act 1986 and the introduction of licensed insolvency practitioners it became convenient to distinguish professionals engaged in corporate rescue ahead of formal process from insolvency practitioners and the term 'turnaround manager' evolved. As turnaround management boutiques from the US established a presence in the UK the more formal title of chief restructuring officer (CRO) became prevalent. Banks would often make the appointment of a CRO a condition of a standstill agreement and while it has no statutory definition

the term became recognised as an important element of corporate rescue.

### GOOD PRACTICE IN THE UK

Turnaround managers or CROs normally have a background in senior operational management with a corporate organisation, or financial services with a professional services organisation or bank, during which time they would have developed the experience to negotiate and manage stakeholder expectations under extreme financial pressure and to tight deadlines. Regular educational events and annual conferences are run by two membership organisations: Turnaround Management Association UK (TMA-UK) and the Institute for Turnaround (IFT), both of which promote high ethical standards and codes of practice.

### DIRECTORSHIPS, SHADOW DIRECTORS AND RESPONSIBILITIES AND LIABILITIES

Neither the position of turnaround manager nor CRO has precise legal definition in the UK. Accordingly the terms of engagement and duties must be defined in an engagement letter which should be clear on scope and reporting responsibility. Whenever possible this should be a direct report to the chairman or board of directors to ensure the turnaround manager has the requisite authority.

The position is not consultancy or advisory. It is by necessity hands on and, therefore, is an executive role. It is not necessary to be a statutory director to perform the function and is best avoided so as to exhibit a degree of independence to external stakeholders and a disassociation with directors' past actions. However, it is likely that acting in an executive and leadership capacity will be interpreted as acting as a shadow director and subject to the same duties, responsibilities and potential liabilities as a statutory director. A shadow director is a person in accordance with whose directions or instructions the directors of a company are accustomed to act. A person is not deemed to be a shadow director if it is clear that he is acting in a professional advisory capacity only.

A turnaround manager or CRO should conduct himself within the statutory duties of a director and as if he was a director, while maintaining a position of independence and objectivity to all stakeholders.

As a company enters the zone of insolvency the directors' responsibilities move from protecting shareholders' interests to a duty to protect the interests of creditors. In a potential liquidation if turnaround efforts fail, a director or shadow director may be held personally liable for civil damages for wrongful or fraudulent trading, or criminal damages for fraud misconduct or falsification of accounts. A turnaround manager working in the zone of

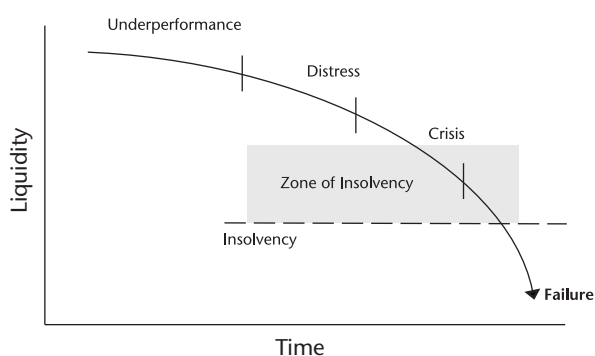
insolvency must acquaint himself thoroughly with the legal implications of his actions and ensure that his decisions are both properly documented and capable of defence. He should act with integrity and transparency at all times. He should ensure his actions maintain enterprise value and do not damage the interests of all or any one group of creditors. In this way he should avoid the potential risks of subsequent legal action. In any event acting with integrity and transparency with all stakeholders will enhance rather than undermine the chance of a successful outcome. It is not just an ethical approach to turnaround but the most practical one.

## SCOPE AND DEFINITION OF A TURNAROUND

### POINT ON THE DECLINE CURVE AND THE ZONE OF INSOLVENCY

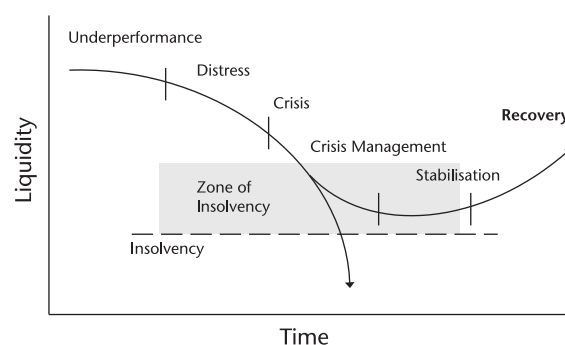
Companies are dynamic. They are either moving forward or backwards against competition. When moving backwards management has the opportunity to change policies to reverse the trend. When management fails to address the issues and falls into a state of denial they embark on the decline curve (see figures 1 and 2). They may institute a change of direction from internal action while they have the liquidity to manage the necessary changes to management and policy. Or they may continue down the decline curve until their financial position makes them vulnerable to an external shock such as loss of a major customer or contract. At such time they are likely to be in the zone of insolvency and under liquidity pressure. Turnaround management actions discussed in this guideline relate to turnaround management at this point of decline. As this will be a point of extreme creditor pressure, turnaround with consensual creditor

Figure 1: The Decline Curve



support and turnaround by leveraging concessions under threat or other near insolvency-related processes become intertwined and these issues are considered below.

Figure 2: The Turnaround



### WARNING SIGNS

In an entrepreneurial society there will always be business failures. What is essential is a mechanism to rehabilitate failing companies to preserve as much value as possible. As live companies are inherently worth more than dead companies early recognition of failure means earlier turnaround action and increased chances of success. However, management can be the last to recognise the symptoms, or action the remedies, and remain in denial until it is too late. Recognising the symptoms from outside is less easy to achieve but nonetheless there are telltale signs.

There are two basic approaches to evaluating risk of business failure: the statistical approach and the intuitive approach. The former depends on the availability of accurate and timely data and uses statistical analysis of liquidity, profitability and gearing to evaluate the likelihood of an insolvency event against a benchmark of historic data. It is more relevant to larger publicly traded companies with complex capital structures where information is in the public domain than small- to medium-sized companies.

The intuitive approach is more familiar to readers of financial statements and observers of business and management. While based on the same factors as the statistical approach it relies on reader judgement over statistical evidence. The financial symptoms are those of declining profitability, declining sales and margins all of which lead to liquidity pressure, inventory build-up and collection and aging problems on receivables. As the process continues the company begins to miss forecasts, both profit and cash. Funding headroom diminishes and covenants come under threat. Supplier payments get extended leading to production scheduling problems.