

## VIEWPOINT

## Deepening Insolvency: Consultants Must Mitigate The Threat

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Michael Cavan

The term "deepening insolvency" used to mean a brief budgetary drought every time I entered a Harley Davidson parts department or wine shop. But it has become the latest industry buzz word to which every turnaround practitioner must pay attention. And although time will tell how this plays out in the courts, the concept is very real with significant implications.

Turnaround consultants are faced with numerous pressures, even in a noncrisis management role. The debtor's overall business must be digested, management assessed, information systems reviewed and cash flow analyzed. Those responsibilities combine to make for a very intense time at the beginning of an engagement, placing extreme time pressures on the turnaround team.

Now, more than ever, consultants have to be extremely careful to ensure that they are successful and can defend every critical business decision. The turnaround team must now also play a more defensive role due to the added threat of a deepening insolvency action. In such an action, a plaintiff claims that the party being sued caused a deterioration of the value of the debtor resulting in damages in the form of a reduced payout.

The business environment has changed with the proliferation of very sophisticated parties: multiple constituents to keep in line with the overall goal of a successful reorganization and access to more information than previously thought possible. The cost of taking a more defensive role in the way each case is managed is necessary to mitigate the cost of defending a deepening insolvency case - not to mention the negative impact on reputation.

Turnaround practitioners, though, have many effective tools at their disposal. A new multiple-weighted-variant Z Score was produced with much more historical information to back up the altered components and their respective weighting. The 2005 edition of Corporate Financial Distress and Bankruptcy by Edward I. Altman and Edith Hotchkiss outlines the changes in minute detail. The use of traditional ratio analysis in combination with the multi-variant approaches provides a much better picture with which to measure the current status as well as progress of the turnaround.

Additionally, the emergence of the Turnaround Management Association as the leading international organization for corporate renewal professionals, with the related Certified Turnaround Professional designation, has produced better trained practitioners. This has led to better sharing of information in the form of "best practices." Added to this, of course, is the phenomenal development in the computer world. Once the financial models and new Z Score analysis are set up, the practitioner can constantly monitor the status of the debtor.

The most important question is: How does the consultant mitigate exposure to the increasing threat of a deepening insolvency course of action? The following items in the proverbial toolbox should be included in work plans and working papers.

### Responsible documentation

This sounds obvious, but when in the midst of a busy case, it can be difficult to keep the administrative memos about each decision current. This is true, especially in light of the numerous factors affecting every turnaround, including financial and operational aspects, and the ultimate ripple effect of each decision on these components. Documentation should be concise and descriptive. It is important to note that any docu-

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mentation may be subject to discovery and, therefore, should be carefully drafted and reviewed by senior practitioners.

#### Disclosure to key constituents

It is critical to keep the key constituents informed. As the cash flows are prepared and reorganization plan developed, it is important to ensure that parties affected by the critical decisions are aware of the chosen path. It will be easier to defend, or avoid altogether, a deepening insolvency course of action if there is buy-in from the secured lenders, unsecured creditors or any other party who may be negatively affected by decisions made.

#### Utilize the Association of Certified Turnaround Professionals (ACTP) Body of Knowledge Course Materials

Every CTP has been provided with excellent material on legal, managerial and accounting topics, recently made available to any interested person at [www.actp.org](http://www.actp.org). Following the steps toward a successful turnaround won't only assist with the case, but also help defend key actions taken during the engagement.

#### Utilize the new Z Score

Financial information produced during the course of the engagement and pro-forma financials to be included in the plan should be entered into the new Z Score model to see if things are tracking in the right direction. Practitioners have utilized the Z Score in the past to measure ongoing success and the new Z Score should prove to be even more effective.

#### Reasonable due diligence

Out of the gates, it is important to fully understand the information on-hand. Often the debtor's books and records are less than stellar. Performing reasonable due diligence and preparing related notes will help ensure that the "starting point" is appropriate information upon which to build the projections. The starting point must be accurate and defensible to then prepare a viable plan.

#### Avoid denial

Don't get caught in the age-old corporate problem of denial. Remove emotion and take a cold hard look at the viability and feasibility of the debtor at the beginning of the case. An honest assessment will help avoid a scenario where further deterioration leads to a failure of a debtor that was never a real candidate for a turnaround.

#### Work as a team

On larger cases, there are several key practitioners on a turnaround team. Brainstorm with this team and document each critical decision, including the related assumptions. On smaller cases, this can be completed through an internal senior person at your firm. It may be a fee that will be written off, but it will help ensure you are immediately ready to defend your critical decisions should the need arise.

A turnaround professional doesn't have to be strangled by the emerging threat of a deepening insolvency action. The consultant must remain creative while bringing expertise to the boardroom. And, it is often "out of the box" thinking that has made the difference between a successful turnaround and a company facing liquidation. If the above points are followed, the turnaround consultant will continue to make the difference in helping troubled companies survive while avoiding a deepening insolvency action.

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