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Dealing with financial distress

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Osler partners Mary Paterson and Marc Wasserman were among the experts helping directors to understand the board's role in preventing and managing financial distress.

Faced with a 'hopelessly optimistic' management team, it's the board's job to track risk, bolster liquidity and avert disaster

When most individuals accept a directorship, they don't join the board expecting that the business will hit hard times. But if an entire board fails to anticipate and prepare for the possibility of financial distress, a crisis can strike suddenly and the response from the top can come too late.

To help directors better understand a board's role in predicting, preparing for and managing financial distress, the Institute of Corporate Directors and the law firm Osler Hoskin & Harcourt LLP have been hosting a series of discussions across the country.

"If you don't have liquidity, you've got nothing," panelist Alan Hibben, an experienced director and financial executive, told a Toronto audience at the launch of the series in November.

Hibben is widely credited with helping steer mortgage lender Home Capital Group Inc. back from the brink. Appointed to the board in May 2017, in part for his experience in restructuring financial firms, he helped put in motion a series of actions that ultimately shored up Home Capital's finances, restored public confidence and led to a full recovery.

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Hibben continues to serve as an independent director of Home Capital and is chair of Hudbay Minerals Inc. and the Mount Sinai Hospital Foundation. He also serves on the boards of DHX Media Ltd. and Extendicare Inc. When asked what information boards need from management to assess the risk of financial distress, he was crystal clear.

“You can have all sorts of accounting measures,” he said, “but the focus of the work that boards should do is on existing liquidity, future sources of liquidity, future uses of liquidity and where liquidity might come from if things start to hit the wall.”

Hibben’s insights were just one of a number of key takeaways from the panel that also included Daniella Dimitrov, a veteran director and partner at Sprott Capital; Andrew MacDougall, partner and head of Osler’s corporate governance practice; and Marc Wasserman, partner and national chair of Osler’s insolvency and restructuring group. The panel was moderated by Mary Paterson, a commercial litigation partner at Osler with expertise in insolvency and tax matters.

This article summarizes their observations and incorporates material published in a companion report from Osler, “Financial Distress – The Board’s Role.” The work is based on an earlier director roundtable, contributions from Osler’s experts and a survey of ICD members conducted last year.

Trouble ahead

Oversight of financial risk management is a core board responsibility, and its effectiveness hinges on the metrics management tracks and reports to the board. Directors must ask: Do those metrics adequately highlight the possibility of financial distress before it becomes a reality?

In the ICD survey, two-thirds of directors said they received specific reporting from management designed to highlight the risk of financial distress and more than 80 per cent said they believed their board receives adequate disclosure in this regard. The metrics most frequently cited were cash and revenue, cash flow, decreases in revenue, and decreases in cash reserves.

Yet financial distress still occurs, and when it does, it often comes as a surprise — a sign that at least some boards aren’t getting the right information.

To counter this, Hibben said directors must recognize that management is, by nature, “hopelessly optimistic.” Even if they track the right data, “they tend to look at it with more rose-coloured glasses than we might, particularly with respect to their relationships with their banks.”

One solution: Require management to run “what if” scenarios against budget projections. Apply non-normal distributions to things like materials prices or sales, and then determine their impact on liquidity or cash flow. “Your job as a director is to push these sorts of questions and ask whether this type of thinking has been done and to ask for evidence that it’s been done,” said Osler’s MacDougall.

Another important consideration is for directors to understand exactly what cost levers are at the company’s disposal if money gets tight. Know your fixed costs and which capital expenditures can be deferred; look at commitments and contingencies that might be triggered if you head into distress. “You’re going to need to build all those things into your scenario analysis,” said Sprott Capital’s Dimitrov.

It’s here that a cold hard look at liquidity comes in. Ready access to capital buys time and options. However, there is often a wide gap between the capital that management thinks is available and the amount that’s actually there when needed. Internally, boards often overestimate the liquidity available from cost-cutting and asset sales, for example. When looking at external sources of capital, Osler’s Wasserman stressed that most credit agreements and lending facilities are discretionary. In tough times, “banks can take steps to reduce that borrowing base.” In other words, the money is there until it isn’t.

Boards should recognize this and ensure management is willing and agile enough to bolster capital resources when capital is available. “You can never have too much capital,” said Dimitrov. “Take the liquidity when the liquidity is being offered.”

Panelists Daniella Dimitrov, Director and Partner at Sprott Capital (left), Alan Hibben, Director and Financial Executive (centre), and, Osler Partner Andrew MacDougall (right) discussed key takeaways for dealing with financial distress.

Distress ensues

When a company is at the point of experiencing severe financial constraints and cash-flow issues, a board’s responsibilities shift.

The immediate next step is to execute a formal response plan — assuming there is one. Responses to the ICD director survey revealed that 66 per cent of boards have no plan, a glaring weakness that may trigger a “deer in the headlights” reaction.

A plan describes who is responsible for what; how reporting, confidentiality and disclosure will be managed; who are your key stakeholders; and what objectives and options are to be pursued. Creating this type of plan also helps boards recognize and address expertise gaps in advance.

As events unfold, companies routinely use external advisers to help with legal and financial issues, personnel and public relations. Sometimes, boards will retain a chief restructuring officer (CRO) to handle the administrative and consultative aspects of a restructuring and allow management to focus on running the business.

Of all the elements boards must deal with when navigating a distress situation, internal and external disclosure is often the area most fraught with complexity and competing interests.

In the early stages, confidentiality is critical. If news of your situation leaks out too early or in an unco-ordinated manner, distress can be self-fulfilling. “If your employees start to catch wind of it, they may walk,” Wasserman said. “Customers may walk. Suppliers may walk.”

On the flip side, transparency with critical stakeholders, such as banks and other lenders, is essential if the company hopes to maintain their support. Ultimately, too, companies subject to continuous disclosure obligations have no choice but to go public regarding matters of liquidity and material changes to the business.

Boards must walk a fine line between avoiding reckless disclosure that might jeopardize a successful turnaround and risking personal liability by not making adequate material disclosures, Dimitrov said.

Directors can further protect themselves from legal liability by seeking external independent advice on the substance of their disclosure. “It will absolutely help feed a due diligence defence,” said Wasserman, as will hiring a CRO.

Likewise, if a board has a pre-existing distress response plan in place and directors can demonstrate that their decisions followed reasonable process, courts will be inclined to rule that they have met their fiduciary duty to act in the best interests of the corporation.

Alan Hibben, second from the right, discusses preparing for and managing financial distress as a director. From left, panelists Mary Paterson, Marc Wasserman, Daniella Dimitrov and Andrew MacDougall.

Resolution

One of the most important strategic decisions faced by directors of a financially distressed organization is determining whether to seek a court-based solution or negotiate a deal with creditors.

The two biggest advantages to a private agreement are having greater flexibility to design your solution, and achieving significant cost savings. Conversely, a court-based solution

(under either the Companies' Creditors Arrangement Act (CCAA) or the Bankruptcy and Insolvency Act (BIA)) has the primary advantages of affording the company protection from creditors, locking in suppliers and encouraging self-interested parties to focus on the situation as a whole.

The decision to go to court may also depend on whether the distress is due to a balance sheet problem or an operational issue, Wasserman said. "If you have an operational problem [and] you need to shed some contracts or some locations, you may need to do it through the CCAA."

Hibben closed by cautioning the audience that many directors' first instinct — to resist court-based solutions in order to hold on for the benefit of shareholders — may be a mistake. "[It could be] you've actually made the situation worse for the creditors, the pensioners or the labour unions by trying to stretch out the consensual part of the negotiation."

Being sensitive to financial risks, realistically assessing liquidity needs and sources through scenario planning, and seeking expert support early are important measures for preserving the most value of an organization for the benefit of all its stakeholders.

Access the full report: Financial Distress – The Board's Role

Brian Banks *is a writer, editor and communications adviser with experience in business, governance and board/C-suite topics. He was an Editorial director and co-founder of* Listed *magazine and is a former editor of* Financial Post Magazine*. He is a Fellow of the Royal Canadian Geographical Society and also writes extensively on natural science, geography, sustainability, ecology and conservation.*

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