NachmanHaysBrownstein
A Team of Leaders

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Howard Brod Brownstein, CTP
Principal, NachmanHaysBrownstein, Inc.

Introductory Remarks

Thank you, Professor Marshall and other esteemed faculty, aspiring students, fellow alumni, and colleagues from the turnaround professional. It is both an honor and a personal privilege for me to be back at HBS, revisiting the site of the halcyon days of my misspent youth.

When I was a first-year MBA student in the 1970's, no one talked about "turnaround management". The hottest career path at HBS was investment banking, followed closely by real estate development and venture capital. The notion that businesses could fail—companies of the sort for that recruited at HBS—was completely out of the question. Any suggestion that business school students should bother to learn about corporate renewal, turnaround management, restructuring and the like—let alone bankruptcy—would have been greeted with disbelief, if not derision.

Across the river at the Law School where I was also fortunate to spend some time, bankruptcy law was not a popular course (if it was taught at all—I truly do not remember!). Prof. Vern Countryman's course on Creditors' Rights was taught primarily from the viewpoint of lenders, and attended, of course, by future attorneys for lenders. Prof. David Herwitz' Business Planning course, often regarded as the only law school course offering at the time truly dealing with the typical American business enterprise—small, closely-held companies—covered many real-world aspects of the law, but not much about turnarounds or bankruptcy. In fact, bankruptcy law was not a highly regarded field, with most white-shoe law firms that recruited at Harvard Law School listing bankruptcy, along with domestic relations and criminal law, as the areas in which they did not practice.

Bankruptcy was virtually unheard-of among respected business enterprises. In fact, the landmark failure of the Penn Central Railroad in the early 1970's shocked

American industry with the realization that a pillar of the economy could actually fail. Still, that was just a *railroad*: a common carrier, a quasi-public monopoly, heavily regulated, a vestige of the 1800's. No multibillion dollar company—let alone an industry leader—could ever fail!

Fast-forward to the present day: business bankruptcies are at an all-time high. Any lingering public squeamishness about bankruptcy has been benumbed by the failures of Enron, Global Crossing, Kmart, several major airlines and many other once-prominent companies. We have been too distracted by headline-topping controversies about corporate governance and excessive compensation, to think about the *real* upheaval in our economy—the fact that virtually *every* company, regardless of its size or ephemeral dominance, will likely go through one or more periods of serious jeopardy to its existence during its business lifetime. It is probable that every business will be in need of a turnaround effort at some point if it is to survive, and many will not.

Indeed, bankruptcy has become a business-planning tool, with the prepackaged bankruptcy, or "prepack", an often-considered exit strategy, and a sale pursuant to §363 of the Bankruptcy Code, a familiar method of "cleansing the assets".

PriceWaterhouseCoopers[1] has predicted that bankruptcy filings by public companies in 2003 will stay at close to the pace of 2002, for another near-record year. Assets involved in such filings are forecast to drop only slightly, from over one-third trillion dollars in 2002 to just under one-quarter trillion dollars this year.

So, anyone here think you need turnaround skills? Having a well-known and successful turnaround or restructuring on your resume—or even having gone through a Ch.11—is likely no longer a stigma, and is possibly even a "red badge of courage". Your next boss knows you don't faint at the sight of blood, and that you've learned first-hand that turnaround is a process, not an event. If you've been through a bankruptcy, you know all about the U.S. Trustee (not to be confused with the Bankruptcy Trustee), about Plans of Reorganization, cramdowns and preferences. What a valuable manager you are, having crossed the River Styx and—eluding Cerberus, the three-headed dog who guards the gates of Hades, returned to tell about it!

What constitutes a successful turnaround? The definition has clearly changed. Once it meant righting the ship, getting back on the original course, resuming the former trajectory. No longer: it's the rare turnaround today that achieves a real bounce from the experience, and roars back stronger than before. Today, many turned-around companies can resemble poodles that have been to the barbershop—barely recognizable, but alive. Others get acquired by strategic buyers that can realize (and pay for) more value from the operations and assets than a financial buyer can, and so the corporate existence of those businesses may change completely.

Turnaround management implicitly involves optimization—the achievement of the best result under the circumstances. And the "circumstances" involve competing

[1] *Troubled Company Reporter*, March 4th, 2003

stakeholders whose interests are often at serious odds in terms of what turnaround strategy is pursued.

For example, in the turnaround of a retail chain, it is frequently necessary to consider closing unprofitable stores. However, if the enterprise gets smaller in order to create short-term profitability and protect creditors, it may leave the equity "out of the money", whereas keeping the store network more intact, but less immediately profitable, may be riskier but may also preserve a greater upside potential for shareholders.

Turnaround management is usually played out with the specter of bankruptcy at least in the wings, if not the backdrop scenery. Stakeholders are continually measuring whether they'd be better off in "a proceeding". And as many corporate officers and directors learn too late, when the business enters the "zone of insolvency", their fiduciary duty is owed to creditors and not just to shareholders.

Large vendors and customers deal differently with companies in turnaround mode; they take steps to avoid getting stuck in an executory contract that they won't be able to break if their trading partner files bankruptcy, even though performance is in danger of suffering. Employees start to migrate elsewhere self-selectively, with the most employable staff members leaving first. Intellectual capital and key relationships walk out the door. A feeding frenzy can begin as competitors smell blood in the water.

Let us pause… If anyone feels dizzy and would like to get a drink of water or perhaps a breath of air, now would be a good time.

What skills do you need to participate in a turnaroiund, or even lead one? Can these skills be taught at HBS or any business school, or is turnaround management a *practicum*, best learned in the 'hood? Here are some basics, but like many other life-changing experiences, until you've been through it, it's hard to describe.

Turnaround management is often compared to the practice of medicine, or more accurately, battlefield surgery—no anesthetics, no lab tests. It's probably no coincidence in my life that at an earlier point in my career I was an Air Force medical triage officer. While no two patients are exactly alike, principles nonetheless apply.

It's dangerous to be too doctrinaire about turnarounds, or to think there's a cookbook approach. The Turnaround Management Association, through its affiliate the Association of Certified Turnaround Professionals, has utilized a "turnaround matrix" in its review courses for the certification exam, which lists five phases that can be identified in many turnarounds: Management Change, Situation Analysis, Emergency Action, Business Restructuring, and Return To Normalcy. While these phases will likely telescope or overlap one another, the activities that each represents do regularly occur in turnarounds.

The first phase involves a change of leadership, permanent or temporary. The reasons are several: most managers are not trained for, or experienced in, turnarounds.

Just as ship captains turn over the wheel to the harbor pilot when they enter the difficult tides and currents near the port, a different skill set (and, perhaps, temperament) is required for a turnaround. Difficult decisions may have to be made affecting the lives of many people, and the survivors among them who will still have to work together. A turnaround professional can serve as a lightning rod for the emotional upheaval that can accompany rationalization of facilities and downsizing, if that occurs, and then hand back the helm to the permanent management once the crisis is over. Perhaps most important, lenders and creditors may have lost confidence in the previous management, and may require a change at the top as a condition of their financial support.

The turnaround leader will want to do two things immediately: 1) determine short-term cash flow; and 2) identify a turnaround team. Cash is not just "king", it is oxygen, it is the lifeblood of the company. The turnaround leader has to determine whether the company is approaching a wall and if so, how far away it is. Second, the John Wayne image of turnaround leaders notwithstanding, I haven't seen many turnaround leaders that can analyze the situation, formulate alternatives, and implement action plans, all by themselves. A turnaround team is needed, utilizing resources within the company to augment and leverage the turnaround leader. If the turnaround leader is from a professional turnaround firm, there will likely be other caseteam members from the firm.

Without belaboring a point that has itself been the subject of conferences, defining the turnaround leader's role is crucial. Scope of Work and goals are the starting point. Responsibility and authority must be congruent. Compensation structure must create alignment of interests. Legal niceties—especially those created if bankruptcy is a possibility—must be observed. For example, if the turnaround leader is labeled or is *de facto* an officer, and the company subsequently files bankruptcy, that officer and his turnaround firm may be disqualified from continuing to provide services. This situation is preventable with the proper planning and foresight.

In analyzing the situation, viability of the business must be confirmed. Is there a "pony under the pile"? Is a turnaround possible? Are there sufficient financial and human resources available to implement the turnaround? Is there enough time? What protective measures for assets have to be taken immediately?

Early-stage action plans will typically focus on cash. Profit-and-loss considerations, effect on EBITDA and other accounting concepts, will typically be shoved aside while the company's survival is assured. Precious cash resources may be rationed to support critical operations and vendors. Turnaround team members may fan out to reassure employees, customers and suppliers.

And a turnaround strategy has to be formulated: what alternatives are available? Will we kick or play? Selecting among turnaround alternatives has a lot to do with identifying and managing risk. What are the risks of each alternative? Who is being asked to bear those risks? How can these risks—and the management of the risk—be monitored and reported?

Assuming a turnaround strategy as been identified and selected, the long-term changes of the business can begin. This usually involves restructuring, both operationally and financially. A common mistake is to try to "fix the balance sheet" first, before fixing the company. Long-term financial restructuring has to follow, not precede, the operational turnaround. What got the company into trouble? Besides the immediate "symptoms", what were the root causes? Why should we reasonably expect that the future will be any different from the past? How will we measure and report progress?

If the turnaround has "taken", there will then be an effort to return things to a more normal basis. Presumably, permanent changes will have been put in place to prevent recurrences of the old problems as well as new ones, and new yardsticks and reporting systems will have been installed to satisfy all stakeholders that there will be no relapses. If crisis or interim management has been installed, then metaphorically speaking, the helm will be handed back to the ship's captain, who may be a new face if the old one was part of the problem or has been too weakened by the experience.

These days there is far less patience on the part of lenders for an extended turnaround effort, especially where the lender has to get in any deeper than they already are. Even where the lender is seriously "under water" in terms of how it would fare in a sale or liquidation of the business, many lenders seem to prefer an earlier out, taking whatever pain is necessary right away rather than wait. So there is a trend among lenders to require an investment banker's assessment of the salability of the business at the outset, even while the turnaround leader assesses the situation. Also, lenders are increasingly selling off loans, either individually or as a portfolio, again taking an immediate write-off rather than trying to recoup their losses. The successor to the lender's interest may have a very different viewpoint; for example, a buyer of the debt at a discount may be even more determined to capture its hoped-for profit early, and might be even less inclined (or completely unable) to lend additional funds. The successor will not have had the historical relationship with the borrower, for whatever that's worth.

A word on ethics: distressed businesses often bring out the worst in otherwise good people. Just as in the Japanese proverb, which states that when the water level of the pond decreases, the rocks appear, so do examples of fraud and abuse seem to escalate when things get rough. The turnaround leader has to be constantly on the alert for the signs of wrongdoing, and especially not to get advertently or inadvertently caught up in such activities. We could devote an entire program just to this topic. Let's leave it at this: adopt what the British MI5 used to call "Moscow rules": assume the dogs are on you 24 hours a day, that everything you say is being recorded and everything you write is being shared on the Internet. Become conversant with Title 18, United States Code, Chapter 9, §§151-157 *et seq.*, the bankruptcy criminal code, since its tripwires are subtle to understand and often hidden from view.

The turnaround management "community" is a broad, vibrant and varied group, The Turnaround Management Association has nearly 6,000 members, of whom only about a third are turnaround professionals, with the balance dispersed among lenders, attorneys, and other service providers like appraisers, auctioneers, liquidators, etc. There is a TMA chapter in every major city and several foreign countries, with chapter meetings nearly every month, and several regional and national programs annually. Attendance at those meetings are a good way to "break in" to the turnaround community and learn more about turnaround management in your area, including check out employment opportunities. The Turnaround Management Association, through its affiliate, The Association of Certified turnaround Professionals, sponsors a certification program which seeks to establish a minimum credential level that distinguishes those for whom turnaround management is a professional career, versus those who are just between permanent jobs and seeking turnaround consulting as the flavor of the month. The CTP designation requires five years experience as a turnaround professional, passage of a rigorous exam based upon a Body of Knowledge in law, management, accounting and finance, references and a background check, and a continuing education requirement.

It is really heartening to see turnaround management being taught and studied so intensively at Harvard Business School. I hope that this will become a regular fixture of the curriculum, and not subject to the vicissitudes of the national economy and the job market. In particular, I hope that within every discipline taught at HBS, there will be a "what if it don't?" component: how do accounting ,finance, operations, human resource management, strategic planning, business policy, international business, and on and on—how do all of these address what to do in a turnaround?

Thank you very much. I'm looking forward to a great program today.