

# Bankruptcy Law Review

VOLUME 2, NO. 3

FALL 1990

Turnarounds

## Integrating Services: The Lawyer and the Turnaround Specialist in Chapter 11 Cases

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Jim Mayer

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There has been a natural competitiveness between the attorneys and turnaround specialists involved in sorting out the affairs of a troubled company—or preparing it for Chapter 11. Their jobs, after all, are different. The attorney will look to the legal issues involved, weighing each step in the company's response to a crisis in terms of which rights that step will safeguard or jeopardize down the road. The turnaround specialist, on the other hand, has an operational perspective, and so is necessarily more interested in the judgment of the balance sheet than in that of a court.

Their goal, however, is the same—steering the company to a revitalization. To this end, attorneys and turnaround specialists are increasingly taking a "team approach"; integrating their efforts—and those of accountants and other professionals—in pursuit of the common goal.

## The professionals enter the case

A Chapter 11 filing may be preceded by weeks or months of preparation, planning, restructuring, and remediation. It involves the services of outside legal advisors and, increas-

ingly, turnaround specialists skilled in workout and crisis management.

In most cases, the decision to seek legal counsel is made when the management realizes that complex negotiations over current or contingent liabilities might result in an insolvency and threaten the continued viability of the business. Management sees external circumstances that cannot be effectively dealt with using its normally available tools and remedies, and are therefore beyond its control.

Turnaround specialists are far less understood by management—and their lawyers. In the past, turnaround specialists have occasionally been cast in a negative light, often as glorified auditors, leveraged into troubled companies by anxiety-prone secured creditors, walking a fuzzy line between genuine advisor and functional operative carrying out lender initiatives. On the positive side, the workout specialist has been portrayed as a "corporate messiah," or "turnaround artist," displacing existing management, working nebulous magic in downsizing, and cutting away waste in the rehabilitation process.

Unfortunately, history has been less than kind to the image of the turnaround practitioner. Many people remember infamous cases in which lenders insisted on third parties, either advisors or interim managers, who usurped operating authority and control in ways that were later deemed egregious, resulting in legal dis-

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putes. One such dispute resulted in the much-ballyhooed lender liability case of *State National Bank of El Paso v. Farah Manufacturing Company, Inc.* (678 S.W. 2d 661 (Tex. App. 1984)).

That litigation brought out a questionable "alliance" between Andrew Galef, a turnaround specialist, and the State National Bank of El Paso, the lender of record to Farah Manufacturing. Originally, Mr. Galef was employed to liquidate assets, with much of the proceeds inuring to the benefit of the secured lienholder. However, his activities resulted in a seesaw struggle that saw William Farah lose his CEO post to Galef, only to regain it later, alleging mismanagement by the "bank's" consultant. In retrospect, the two roles—consultant/"liquidator" for the bank and "interim manager" for the company—were too close. The ultimate decision favored Farah, including a record award running into millions of dollars. Since then, lenders have universally exercised care in recommending turnaround specialists to whom they have no antecedent connections, such as serving in a liquidator or advisory role to the bank or financing entity.

***Attorneys and turnaround specialists are increasingly taking a "team approach" in pursuit of a common goal.***

Today, however, turnaround specialists are showing up *before* the crisis. They are being sought by trade creditors, customers, insurers, stockholders, bondholders, accountants, and even lawyers. The concept of "turnaround teams" is now finding favor with both the legal and the turnaround specialists working in Chapter 11 cases. Turnaround specialists are found in courtrooms, but not as part of lender liability cases. Instead, they are presenting alternative business plans that support efforts to keep the automatic stay in place or prevent the appointment of trustees or examiners. They also help in developing the core data for disclosure statements and reorganization plans. In short, the notion of a *team* that includes not only the debtor's management (if management's role has not been assumed by the

turnaround manager) and accountants, but also the turnaround specialist and lawyer, is becoming a functioning reality in many smaller and middle-market bankruptcies.

**The specialist's role.** The role of the turnaround specialist in the turnaround team will basically be that of either a manager or a consultant. Regardless of the name given, the manager's role requires the actual assumption of company's direction. The consultant's role, by contrast, is that of an advisor, augmenting the expertise available to management in the strategic, financial, and operating issues peculiar to the various stages of a turnaround.

Both consultants and managers will be deeply involved with identifying issues affecting the company's viability, mitigating crises, rehabilitating and remediating both operational and financial damage, and reformulating alternative strategies and business plans to achieve revitalization of the entity. These issues complement the lawyer's offensive and defensive positioning, strategy, and case management, and serve the goals of having both a consensual disclosure statement and a reorganization plan approved.

**Circumstances and timing.** A turnaround specialist who is hired early in the crisis can subsequently bring the lawyer an objective and comprehensive knowledge of the peculiarities of the case in an efficient and pragmatic manner. Unfortunately, it is not often done. Even more unfortunate is management's use of consultants in isolation, dealing with counsel separately. More often than not, the CEO may have played a role in engaging both professionals at different times, but avoided any connections of the two prior to filing, fearing a consensus of opinion about issues of mismanagement, conflicts of interest, or even blatant negligence.

Of course, isolation is greatly mitigated when a turnaround manager *becomes* the CEO (or CFO). If the antecedent management is removed early enough, the specialist/manager should have developed a short-term operating and financial plan that adequately informs and prepares counsel for filing under Chapter 11.

In larger companies, suggestions and subsequent action to replace management may come from any number of sources. However, the Board normally decides to interview prospective turnaround managers. Once the decision is

made, a set of criteria is established and contracts are drawn, giving substantial or even total operating authority to the manager. In some cases, that authority has priority over normal Board decision-making power.

This action usually precedes a Chapter 11 filing. It can, however, occur after the case is initiated. Depending on the level of creditor contention, a postpetition agreement to employ an interim manager must entail counsel's involvement, due diligence, and support. Carried out correctly, a credible third party can effectively head off a move under Section 1104 to appoint an examiner, which conceivably could precede total control of the estate being ceded to a trustee at some later point.

### Impediments to the turnaround team

It seems clear that the teaming of turnaround specialists and bankruptcy lawyers is not only appropriate, but could represent a formidable merging of talents. Yet there are differences between the two communities that have to be addressed when they team up.

The term "professional" has history and substance for the legal profession. Lawyers have well-defined codes of ethics, bar entrance requirements, licensing procedures, censure provisions, mandatory educational backgrounds, and a general protocol in dealing with others in the profession.

*In the past, turnaround consultants have occasionally been cast in a negative light.*

Turnaround specialists are largely unregulated. They practice without formal requirements of education, practice standards, ethics, licensing, or censure. They are generally not recognized as a profession. Teaming the lawyer with the turnaround specialist seems incongruous to many. Yet, turnaround specialists' case histories reflect a fair share of voluntary high standards of professional practice, largely built upon by experience. Moreover, conflicts of in-

terest, bad faith in abusing control, and fraud are rare among the practitioners who have practiced enough years to gain respect by various creditor constituencies.

The preponderance of opinion among bankruptcy practitioners is that management quality and perception is paramount in a successful Chapter 11. Does it require professional turnaround practitioners or just good managers?

**Organizing and professionalizing.** A research study on business failure and the turnaround process evolved into a loosely knit band of turnaround specialists branded "Soldiers of Misfortune" by *CFO* magazine. In 1988, the Turnaround Management Association ("TMA") was formally organized. Its original charter was adopted to create an awareness of turnaround management within the business and financial communities, develop conferences and seminars, and conduct research on issues of corporate turnaround among and between various constituencies. Part of these goals was an effort to refine what many believed to be an "art form," elevating the practice of turnaround by consultants and managers to that of a profession.

The TMA is now actively working to achieve professional standards of excellence for the estimated 500 turnaround practitioners active in the U.S. today. It is expected that before early 1992, managers and consultants who practice turnaround as a specialty will be able to voluntarily submit to a certification or validation process, providing creditors, debtors, shareholders and governmental constituencies—and bankruptcy lawyers—some expectation of minimal standards and competence.

As the use of bankruptcy becomes increasingly complex, the need for operating and financial specialists specifically geared to business strategy in the turnaround and reorganization process will continue to grow. Turnaround specialists must gain the confidence of those who entrust them with the care and direction of ever-increasingly large enterprises. The degree of influence exerted by these consultants and managers demands professionalism. Standards must be mandatory if turnaround specialists and bankruptcy lawyers are ever to operate as a professional team, where mutual roles are not only understood, but well-defined.

## Combining the practices

When lawyers and turnaround practitioners have confidence in each other, new roles can evolve that may ultimately improve the efficiency and management of the Chapter 11 process.

There are times when turnaround practitioners believe lawyers have stepped into issues of management, however benignly. Conversely, there are times when lawyers feel that turnaround specialists—knowledgeable though they may be of major bankruptcy issues—have overstepped their operating advisory roles into a quasi-legal function, even though such action may have been taken only to provide immediate feedback to debtors without waiting to consult counsel first.

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Thus, the first issue in the creation of a "turnaround team" is how to delineate the specific roles and duties of the participants.

**Early case management.** Most turnaround specialists begin their work with some form of survey. If a crisis exists, the key issues will be stability, forensics (finding out what is wrong), and remediation (fixing it). In preparing for a Chapter 11 proceeding, the operating specialist can be invaluable to counsel in gathering factual data necessary for understanding the case and filing the Statement of Affairs. Moreover, the specialist will need to assess issues of strength and weakness in finances, operations, management, contracts, staffing, economics of the present business configuration, and overall viability.

With this information, the lawyer can identify issues that might affect responses to early offensive moves by creditors to lift the automatic stay, deny use of cash collateral, or define what "they" might consider to be "reasonable" in terms of adequate protection. Moreover, the turnaround specialist's survey might identify negotiating points of weakness with potential adversaries. This might include uncovering

preferences, fraud, documentation problems, or egregious or inequitable conduct. In short, if the debtor's management is unversed in, or simply ignorant of, standard operating procedures in Chapter 11, the experienced consultant or manager can help all parties improve the debtor's position early-on.

**Mid-case management.** There is often very little similarity between what creditors would like the revised business plan to be, and what is needed to achieve the remediation and rehabilitation of the business. The resolution of issues such as operating results, downsizing, or the sale of superfluous assets must be governed by a realistic view of what has to be done to keep the business viable. The turnaround specialist can give counsel an independent third-party outlook—and an analysis of how "micro" issues can, during the course of the case, produce a "macro" effect—that management simply does not have.

The mid-case activities of the turnaround specialist also focus on strategies and relations with creditors. In some cases, preservation of the debtor's options requires the neutralization of objectionable creditors. That can be done through the proper use of collateral issues involving preferences, fraudulent conveyances, contract rejections, or assumptions and post-petition credit adjustments. The strategic employment of these legal issues also profoundly affects development of the business plan, and has to be planned accordingly. The difficulty comes in trying to maintain operating control while achieving the positive creditor relations needed to cement a consensual reorganization. The turnaround practitioner and bankruptcy lawyer can integrate legal options in that context to form a realistic business plan.

**Late case management.** The successful turnaround, having gone through intervention and remediation and progressing toward rehabilitation, has one primary byproduct—a successful reorganization plan and disclosure statement. In trying to avoid repetitive plan amendments, competing plans, and cram-downs, the realities of the case come full circle.

The restructuring possibilities often seem boundless when, in fact, they are not. Ways must be found to steer those who look towards unworkable alternatives back to the sounder footing of the proposed plan. For example, if

the inherent value of the estate merely covers secured and priority claims, the tendency by counsel might be to distribute as little as possible to unsecured creditors. However, counsel may benefit greatly if the turnaround specialist has also determined how much *can* be given to those creditors as an inducement for their support of the plan. For example, if the projections in the disclosure statement prove too conservative, suppliers and other proponents of continued postconfirmation operation could be given a bonus.

While it might ultimately mean that that class of creditor gets 9% of allowed prepetition claim as opposed to a nominal 5%, the inclusion of incentives could well make the difference between a consent or rejection by a particular group of impaired creditors. While counsel may propose this, it is management, the consultant, or both, who must be able to juggle the day-to-day relationships with creditors according to the financial pragmatics of a plan distribution.

On the turnaround team, the turnaround specialist provides pragmatic feedback from operations, while translating legal processes into practical operating strategy. The bankruptcy lawyer provides legal options, the skills and experience that translate into legal strategy, and the ability to move through the legal arena. By joining the issues of business and legal strategy, much trial and error can be avoided and new opportunities for efficiency can be realized for the benefit of the client.

## The future

Creativity and mutual respect, together with the achievement of professional status by turnaround specialists, open limitless horizons for the legal and turnaround disciplines to practice together.

**Education.** At some point, the practical legal implications of bankruptcy may become course material in the training and certification of turnaround consultants and managers. Conversely, practical issues of remediating and rehabilitating troubled businesses may become elective course work in some law schools.

Already, numerous seminars include consultants, managers, and lawyers participating together in the context of unified course work. As

more of the principals behind successful turnarounds become known, researched, and documented, those issues will inevitably be studied alongside the legal precedents associated with their successful use. Hybrid legal and operating strategies will evolve and be taught in business and law schools. Perhaps, turnaround may become a specialty concentration within those business schools that realize importance of turnaround in the United States, today and in the future.

**Trade organizations.** Notwithstanding educational opportunities for lawyers, consultants, and managers to interact and share strategies exclusive to their practices, the cross-pollination between trade organizations is not only possible, but probable.

The TMA is likely to remain the preeminent trade association for both consultant and managerial practitioners. It anticipates the evolution of turnaround to result in professional certification and ethical standards by 1992. Current associate members include various members of the bankruptcy bar.

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The national and regional activities of the various bar groups include the sub-specialty of bankruptcy practice. In major metropolitan areas, members of the bankruptcy section of the bar meet regularly and, increasingly, non-lawyers are being invited to participate in presentations and educational events.

Hybrid organizations blending various disciplines in bankruptcy are growing. Many, like the American Bankruptcy Institute ("ABI"), have developed a focus in specific interest areas. In the case of the ABI, the "macro" concept is furthering the legislative and political process among judges, trustees, lawyers, accountants, consultants, liquidators, appraisers, and members of Congress responsible for amending and adding to the Code.

One can foresee the cross-pollination of the legal and turnaround industries expanding to

include new practice-oriented organizations that include members of both professions. Nevertheless, consultants and managers will inevitably refer business to lawyers and, given an increasing level of professionalism in turnaround, lawyers may soon find it advantageous to recommend turnaround specialists to troubled clients that lack the managerial skills needed in the rehabilitation process.

***Standards must be mandatory if turnaround specialists and lawyers are ever to operate as a professional team.***

**Mergers.** The accounting profession has witnessed an exponential increase in revenues as a result of directly entering the management consulting business. Much of the increase and activities are centered in quantifiable issues such as systems integration and electronic data processing. However, certain new buzzwords have evolved, including "strategic planning" and "quality management." Included in these diversifications into management consulting are forays into workout and creditor rights consulting. Most of the activity has centered in specific issues, such as investigating preferences or tracking cash. However, strategy and even debtor advisory services are becoming "sidebar" activities.

The relatively small number of large, well-organized turnaround firms may provide a similar opportunities for major law firms to purchase or affiliate with consulting and interim management firms. While some attitudes of the legal industry must change to allow this, it is reasonable to project legal and management strategists operating in a formal union on an "arm's-length" basis. Moreover, just as financial service firms are employing turnaround special-

ists to formulate specialized financing to troubled entities, so too will legal firms inevitably see merit to nonpartner "principals" entering their firms, extending their existing legal services to include issues relating to the management of their "unmanageable" clients.

## Summary

The early history of the turnaround practice, and the misperceptions that history produced, have led to a misperception of the turnaround specialist and the role he or she plays. In response, the evolution of the turnaround practice now includes coming moves by trade organizations to professionalize the industry. It is reasonable to assume that both a code of professional conduct and a professional certification process may exist for turnaround practitioners in the near future.

With the elevation of the turnaround practice to a well-defined profession, the principal use of consultants and managers will increase. The legal practitioner will find an ally in the turnaround practitioner and vice versa. The merging of legal strategy with business acumen will lead to more efficient case management and better results. Consultants, interim managers, and lawyers will represent formidable challengers in the reorganization process.

The growth of bankruptcy and the rise in professionalism in turnaround management may ultimately lead progressive law practices to acquire personnel, or turnaround firms, on a directly affiliated basis, wherein mutual synergies can benefit both law partners and turnaround "principals." ■

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