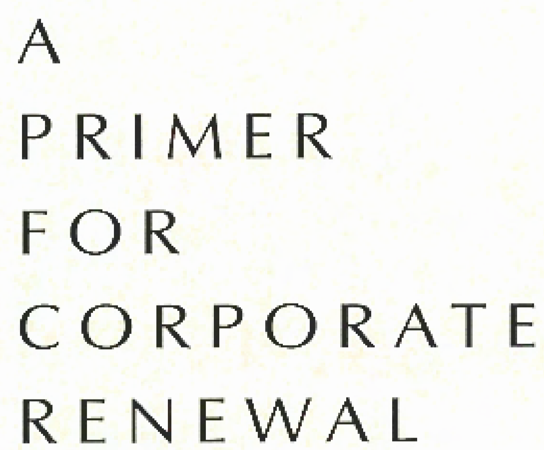
A
PRIMER
FOR
CORPORATE
RENEWAL

TURNAROUND
MANAGEMENT
ASSOCIATION

Dear Member;

What you are holding in your hands represents several "firsts" for the Turnaround Management Association. Through this past year of exciting change and growth, members of the TMA have worked with the organization's newsletter staff to make great strides in both the quality and frequency of publication for, *The Newsletter of Corporate Renewal*. So, for the first time we present to you, our members, what we call *A Primer for Corporate Renewal*. The primer is a compendium of all of the best in industry information and insight that has been presented in the newsletter's past six issues. The knowledge and wisdom packed into these pages is unparalleled, and cannot be obtained anywhere else in our industry. Whether you are struggling with planning, leadership or regulatory issues, this primer will help guide you as you work with your clients, and with other turnaround professionals, in saving troubled companies.

We know that the information presented here is bona fide and valuable because it is from professionals in the corporate renewal industry and leans on years of industry experience. Which brings us to our next "first". For the first time, the newsletter has been put on a regular publishing schedule — six times annually — and boasts an exciting and consistent line-up of articles that hit on the timeliest topics within our profession.

We are proud of the newsletter's growth as a platform for education, exchange of ideas and the advancement of the profession. With TMA members in all 50 states, plus members in Canada and other parts of the world, we consider *The Newsletter of Corporate Renewal* one of the most important forums for viewpoint exchange within the corporate renewal community. More than 9,000 people regularly read the newsletter. Increased, as well as repeated, advertising placements indicate this publication is gaining credibility and recognition as the vehicle to reach corporate renewal professionals.

So with a little more hard work, persistence, and assistance from our most important critics and contributors — you, our members — we look forward to bringing you another exciting year of TMA publications. As the year unfolds, we will make the best effort to be there on the cutting edge of information processing to bring you the timeliest topics within the industry. If it's important you will read about it in our publications — and you will read about it there "first." We would like to thank you for your continued support of the Turnaround Management Association and its publications. And we hope you enjoy reading this "first" *Primer for Corporate Renewal* as much as we enjoyed preparing it for you.

In closing, I would like to personally thank all of the authors who have spent time and exhausted resources providing articles and input for the newsletter. We want you to know that TMA recognizes the amount of time and energy you have spent in assisting in the publication's growth. Looking ahead, we would like to welcome new contributors and the submissions they will bring to the newsletter.

Sincerely,

John M. Collard, CTP
Chairman of the Board of Directors

Compiled and published by

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We dedicate this Primer to all of those who have contributed time and energy and who worked tirelessly to make the ***Newsletter of Corporate Renewal*** *an award-winning success.*

Table of Contents

About the Authors 2

LEADERSHIP

Let Leaders Replace Corporate Managers — Steven Pearlstein — 5
Leadership Has Its Dark—and Necessary—Side — Tom Peters — 6
To Save the Company — Change the Leadership Style — John M. Collard — 7
Pondering Business Change is One Thing...*Enduring it is Another* — John M. Collard — 8
Riding the Roller Coaster of Denial — Rosemary T. Bowes — 9
Communicate in a Crisis; 10 Tips for Managing Crisis Communications — Phyllis Gillis — 10
Winning Through Negotiation; How to Get What You Want at the Bargaining Table — Richard J. Walters — 11

PLANNING & STRATEGY

From Here to ... Where? What is Your Mission? — John M. Collard — 13
Turnaround Leaders Predict More Business Failures in 1993 — 14
Are You Ready for Reengineering? — Carolyn Davis Cockey — 15
Recent Developments... — Wendell H. Adair — 16
Musings From the Mountain—Set Your Priorities, Renew Enthusiasm &Triumph! — John M. Collard & Richard J. Walters — 17
Will Sees Major Challenges for Clinton, *Review of George Will on "This Week with David Brinkley"* — 18
Where in the World Are You Headed? Win Business by Transitioning into New Markets — John M. Collard — 19

FINANCE

Where Do You Go When the Bank Says "No?" — Barbara Anderson — 21
In Lending, There's No Fool Like the "Greater Fool" — Keith F. Lawder — 22
Asset-Based Financing; Understanding Credit Criteria — Michael Lerner — 23
Mezzanine Financing . . . Is it Appropriate? — Jeff Toole — 24
The Subordinated Debt Paradoxes — Wendell H. Adair — 25
Implementing SFAS 106: Employer's Accounting for Postretirement Benefits — Kamal M. Advani — 26
Financial Aspects of Fraudulent Conveyance Analysis — Kamal M. Advani — 27
National Health Care Reform — Charles T. Day — 28

REGULATORY AFFAIRS

Bankruptcy Amendments Act of 1993; Pensions Down; Torts on Hold; Costs Up — Wendell H. Adair — 29
Senate Repeals Stock-For-Debt Exception, May Change the Way People do Turnarounds — John Wm. Butler, Jr. & Kathleen Ninivaggi — 30
Stock-For-Debt Exception Repeal (follow-up) — John Wm. Butler, Jr. — 30
Fiduciary Duties to Creditors Upon Insolvency — Wendell H. Adair & Michael L. Boykins — 31
RTC's Casey: "$25 Billion Will Finish S&L Cleanup" — *Washington Post excerpt* — 31
Financial Advisors Subject to Increased Scrutiny — Wendell H. Adair — 32
Prohibited Discrimination or Comprehensive Legislation? — Wendell H. Adair — 32

OF INTEREST

Calling All Dollars! Beyond the Crisis . . . What's Next? — John M. Collard — 33
Specific Considerations in a Troubled Company — Paul F. Barnes — 34
Diamonds In The Rough — Kamal M. Advani & Dale A. Buckwalter — 35
Landing the Big Ones ... Without Losing Your Bait — Richard J. Walters — 36
TMA Members Become "Good Samaritans," Pro-Bono Help Saves Small Enterprises — Mike Brose — 37
"Avoidum Verbositae Redundae," Hazards to Avoid When Your Asset is Real Estate — Joe Foster — 38

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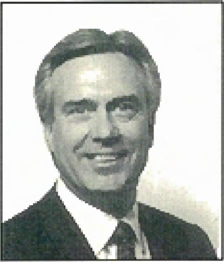
MANAGING EDITOR
Practitioner's View



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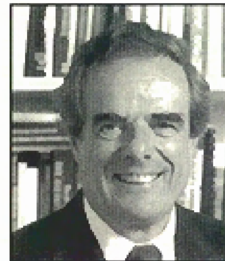

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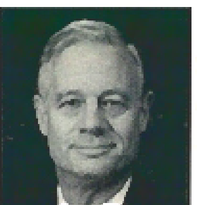

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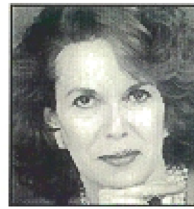

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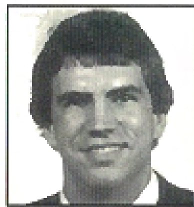

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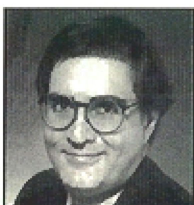

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Let Leaders Replace Corporate Managers

By Steven Pearlstein & Abraham Zaleznik

BOSTON - Now that the performance of the U.S. economy is on the front burner, the Washington policy establishment is busy cranking out ideas about tax rates, free-trade zones, infrastructure investment and the like. The presumption is that the nation's malaise is something that better policies can cure.

But Abraham Zaleznik, a former Harvard Business School professor and trained psychoanalyst, argues that there is a bigger problem with the American economy: The wrong people are running the biggest U.S. corporations.

Zaleznik asks: What if more corporations were run by genuine leaders who took on the role of in-house critic and teacher and kept the management team focused on the substance of their business—the marketing or the production or whatever needed fixing.

This roll-up-the-sleeves approach, he says, is surprisingly rare in big corporations, which favor managers who have mastered office politics, make smooth presentations and have learned to reduce every challenge to a predictable, bureaucratic process.

"The managerial orientation, with its emphasis on form over substance, on structure over people and on power relationships over work, is at the heart of the disability of modern business in the United States," writes Zaleznik in "The Managerial Mystique," published in 1989.

> ***"The managerial orientation... is at the heart of the disability of modern business..."***

Not surprisingly, Zaleznik over the years has been something of an outcast at the Harvard Business School, which perhaps more than any other institution has helped foster the idea that successful business leaders can be trained to take ordinary people and produce extraordinary results by instituting well-proven procedures and techniques.

In its place, Zaleznik preaches a sort of Great Man theory of business success in which a chief executive inspires loyalty with loyalty, unleashes creativity by his own creativity and by example drives out the natural tendency in any organization toward complacency and mediocrity.

Some might call it charisma, a characteristic Zaleznik says is appropriately valued but widely misunderstood.

"I don't think of charisma as a silver tongue or a winning personality or the knack for making a good impression," he said. "It is the consequence of having performed in such a way that people develop a feeling of awe about a process that they have witnessed or participated in."

On Zaleznik's list of charismatic business leaders are Sam Walton at Wal-Mart Stores Inc., automaker Soichiro Honda, Bernard Marcus, founder of Crate & Barrel stores, the oft-maligned Steve Jobs, founder of Apple Computer Inc. and now head of Next Inc., as the sort of leaders U.S. business could use more of. The common thread: All built companies that were successful because they changed the nature of the industry they were in.

Most corporations attract people of similar grit, ingenuity and old-fashioned business sense, he said. Eventually, however, such people are driven out or forced to seek outlets for their creativity outside the company.

"The kind of people I'm talking about, the ones who ought to be running things, their ideas run so counter to the mainstream of thought [in their companies] that people don't know how to deal with them," said Zaleznik.

Zaleznik's approach borrows more from psychology and anthropology than from traditional management theories. "Most corporations," he explains, "are dominated by 'once born' personalities — people who, psychologically, need to feel part of an existing social structure and are constantly adapting themselves to the world around them."

"For these once-born managers, life has been a steady progression of successes, from home to school and up the corporate ladder. As they enter the executive suite, they form a sort of self-perpetuating clique that clings to certain myths about the company's prowess," Zaleznik said. "They frown on conflict, tend to paper over problems and reject anyone who threatens their self-esteem."

Zaleznik contrasts these managers with leaders who are likely to be 'twice-born' personalities - people who at some point in their early lives have overcome some sort of painful conflict that led to a sense of separateness or estrangement from their family, school or neighborhood. That sense of "separateness" gives these leaders the confidence to challenge prevailing corporate myths ("We're the best in our industry") and ask questions that make others uncomfortable, and consider options that others might instinctively dismiss.

"While busily adapting to their environment, managers are narrowly engaged in maintaining their identity and self-esteem through others," says Zaleznik. "Leaders have self-confidence growing out of the awareness of who they are and the visions that drive them to achieve."

"Boards of directors, however, almost invariably pick managers over leaders when choosing top executives. There is a tendency for directors to look for certain kinds of sophistication," says Zaleznik, who serves on the boards of nine companies. "Most obvious is the ability to make presentations. Board members are charmed by anyone who can make the world seem more orderly than it really is."

"The reigning belief is if you don't have predictability and order, you have chaos," he continued. "But that's not true. If you don't have order, you have infinite possibilities."

Two Unsought Abilities

Zaleznik cites two intellectual capabilities that probably have never appeared on the checklist of most corporate recruiters or search committees — but should.

One is an ability to perform "abstract thinking," to move from concrete experience to a set of generalized ideas and back to concrete experience again in ways that fundamentally change the way people think about a problem or an opportunity.

"An abstract thinker might ask, 'What if we weren't in this business, what else would we do with these people, this machinery, this set of customers?'" said Zaleznik. "This is a fantasy, of course, but it is fantasy of a very productive nature."

The other is curiosity and openness to new experiences and ideas, qualities that enable a business leader to empathize with customers, suppliers or employees, and engage in fruitful conversation with them.

"A lot of top executives, when you talk to them, you feel as if you are at a rehearsal. You see it in their eyes, which glaze over as they run through the litany of what they are going to do about debt reduction or how they are going to increase shareholder value. Try breaking through that—it is extremely difficult."

This is not the sort of stuff likely to earn the 68-year-old Zaleznik a spot on this year's list of hot new management gurus. He offers no catchy new buzzword for reorganizing the American corporation and does not carry the flip charts and matrices so favored by other high-priced management consultants. *(Continued on next page)*

Leadership Has its Dark — and Necessary — Side

By Tom Peters

With a new occupant in the White House, talk of leadership is in the air. Most focuses on the "good stuff": ennobling vision, empowering followers, maintaining the common touch.

These qualities are important, and more often than not, lacking in leaders of all stripes. Nonetheless, leadership also has another, less majestic side. My experience suggests the best leaders are:

1. Manipulative. Make no mistake, Bill Clinton (and any other wise leader) is fully aware of the image he projects. Through preaching inclusion, he is a control freak, intent on carefully orchestrating every context to present the precisely desired message. For one small thing, I've never seen a politician so adept at snatching up any baby in sight, then hoisting the toddler into the camera's eye.

Only the leader really understands, holistically, the persona she or he wishes to convey: The best are insistent that nothing get in the way of that presentation.

2. Symbol-conscious. While "getting down to brass tacks" is a must, brass tacks and practical policy implementation are usually possible only if the atmospherics are compelling.

Effective leaders, from Pennsylvania Avenue (none better than Ronald Reagan) to the accounting department, have a sure feel for the symbolic content of their actions. To champion follower involvement, for example, leaders should go out of their way to exhibit involvement (follow a genuine open-door policy, regularly eat in the employee cafeteria, etc.).

3. Dictatorial about the dream. To be effective, a vision must be crystal clear. While compromise is necessary to build a consensus for action, the best chiefs (in retrospect) are insistent that the main theme not get so enlarged or diluted as to become insipid.

4. Narrow-minded. Wise honchos know they can accomplish only limited agendas. The number of important problems and opportunities that confront - and distract - leaders at all levels is staggering. The best tack and jibe constantly, but, at a deeper level, fight to keep the focus on the main event ("the economy, stupid").

5. Punitive. Carrots motivate far better than sticks. Period. Nonetheless, top notch leaders don't idly ignore those who choose to ignore them. Lyndon Johnson was brilliant at translating his contrarian domestic agenda into legislation. He was peerless at dispensing favors at critical moments (to win swing votes); but he was equally firm-handed in ensuring that those who broke ranks in trying times suffered the consequences.

6. Mistrustful. Many good leaders, shop floor to national government, are humanists. Still, the survivors are usually closet conspiracy theorists as well. Most constituents who approach the leaders, in innocence or with guile, have their own agendas. Effective leaders are likely to hide a healthy dose of skepticism and even mistrust beneath a sunny, inspiring exterior.

In the end, the leader alone (and one or two trusted confidants if she or he is lucky - e.g. Hillary Clinton for Bill Clinton) is responsible for himself or herself.

7. Wily. The best leaders are open, honest and accessible; *and* the converse of all three. Leaders must be shrewd tacticians if they are to accomplish anything in a sizable public or private bureaucracy. That means doling out access carefully since access significantly empowers those who are perceived to have it. (If everyone has access, then it ceases to be a carrot or a stick.)

It also means playing some games very close to the vest - offering under-the-table favors tomorrow in return for a key vote today. (Kennedy unraveled the 1962 missile crisis by secretly promising future withdrawal of our missiles in Turkey in return for Khrushchev's immediate public withdrawal of missiles in Cuba.)

And dishonest? While I hardly condone dishonesty, I also don't believe the one about George Washington and the cherry tree. Leaders often put very different spins on an issue, depending on whom they are addressing. This, of course, can and often does result in perceived slickness; on the other hand, to expect saintly consistency is to misunderstand the nuts and bolts of getting stuff done through multiple constituencies.

8. Power mad. These words doubtless bring to mind Hitler, Stalin and Saddam Hussein. Yet make no mistake, the best leaders, junior to senior, are avid students of power. We all operate amid webs of friends and enemies, with every shade of gray imaginable in between. To not understand the nature of the contest is almost surely to lose before you're off the starting blocks.

Am I too cynical? I think not. Leadership is as much about the rough and tumble dailiness of implementation as it is about a transformative vision for the ages. The human condition requires leaders to attend to many factors conveniently overlooked by those who see only the smiling side of the leadership coin. *— NCR, May 1993*

Zaleznik Sees a Need for Leaders Over Managers *(Continued)*

Nor does he have much use for sweeping prescriptions such as "management by objective" or "intrapreneurship" or "total quality management" that have become the mantras of many executives — not because these don't contain germs of good ideas, but because they become the latest new "process" for managers and directors to latch onto. Such processes, he says, become substitutes for doing what he calls the "real work" of addressing the substantive business problems facing their companies.

This preoccupation with process was driven home for Zaleznik several years ago when he met one evening with top marketing executives from some of the country's biggest corporations at an advanced management program at the Harvard Business School. His purpose was to solicit their ideas for improving the school's approach to marketing.

"So I posed them with some questions," Zaleznik recalled. "What is going on in your field? What are the ideas that are generating some movement?"

"Their response was that it is not the ideas in marketing that count, it is your ability to get something across to people who are running things in the power structure. You've got to figure out how to make your presentations, how you time it, how it fits into this year's budget cycle."

"Suddenly, I was confused. I had expected a very stimulating evening focused on changing consumer attitudes and new distribution systems or whatever. And there was not a word. All I heard was the politics of getting things done."

—NCR, July 1993

To Save the Company— Change the Leadership Style

By John M. Collard

Who can handle the crisis management role? This is a predicament. Clear thinking must prevail and a special set of skills must be applied.

If there is a qualified leader within the company, then delegate the job of turnaround to that person — and provide proper support. If there is not a qualified leader in the company, and there usually isn't, don't hesitate to go outside to locate a professional at this type of work. The answer often resides outside the company in the form of a turnaround specialist.

But what guides the decision?

Different companies need different kinds of leaders. The CEO that managed the company while it got into trouble probably doesn't have the skills to doctor it back to health. And conversely, the CEO that can bring a troubled company from the brink of failure may not have the skills to manage long-term, day-to-day operations.

Let's put the leadership role into proper perspective. Leadership requirements differ between those for healthy, growing companies and for those in a troubled situation. Compare the differences in our chart.

SKILL	STABLE OR GROWTH SCENARIO	TROUBLED OR TURNAROUND SITUATION
Focus	On Objectives	On Survival, Action On Problem Solving
Decision Making	Deliberate	Decisive, Immediate
Authority	Delegate	Direct Involvement
People	Develop	Recruit Talent Communications
Respectable For:	Management Reputation	Financial Credibility
Known For:	Consistency	Ability to shift gears

Differences in style are a key to success, in either situation. In the stable or growth scenario, team building and coaching are the buzzwords. But in the initial crisis and subsequent turnaround situation, ***time is an enemy***. Decisive action is required.

The focus is dramatically different. This is one reason why the troubled environment is so foreign to many managers, and hence, the difficulty finding qualified talent from within the company. The stable environment allows for mistakes and longer lead cycles to achieve goals. Troubled companies have primarily one goal — to survive and get well. If the symptoms persist with no cure, the patient can die.

Just as with a critical patient, the immediate focus at a troubled company should be on action — make something happen. The first goal in an absolute crisis is to stabilize and buy time. After calming the waters, take a reading on where things stand — which is normally still. Look for changes in ratios and trends to determine *what is*, or more importantly, *what is not* going on in the business.

Following this diagnostic stage, the transition can begin towards a turnaround. Most importantly, the leader needs to get things moving again. Movement must occur in two areas — On the *Volume* In (revenue/sales) side, look at where and how revenue is generated. Is it from existing customers and contracts or new business? Most importantly, keep it coming in. On the *Volume Out* (throughput/production) side, look at getting the product or service 'out the door'. How else can you bill for it?

Companies often get into trouble because management procrastinates when it comes to making decisions. If the decision is made by default, it is akin to making no decision at all. Much of that early, and overall, survival also depends upon being immediate — upon making decisions in a timely manner. Even a wrong decision means movement and direction. If a decision turns out to be wrong, change it, but keep things moving.

Time is also an important dimension when it comes to authority. In a stable company, there is time to delegate and nurture the growth of the management team; time to work on long-term issues and projects. In the troubled situation delegating takes on a different role. Managers must be held accountable not only for performance, but for timely results.

In a troubled situation, the decision-maker must get directly involved. It is hard to worry about the long-term future when there may not be one. The leader is pressed closer to the immediacy of the day-to-day operations. If you want action, request a decision . . . or make one.

In a stable situation there is time to develop talent. But at a troubled firm, you must exploit the talents of those who can perform and recruit the talent that is lacking. It means building a permanent management team that can bring the company back to health — and add value to the company.

Communication is critical — with everyone who has a stake in the company's success. Talk to employees, but more importantly, *listen* to what they have to say. Be assured, they know when problems exist.

What message are you sending? Remember, what is not said is often more destructive than what is. Unnatural actions or behavior, such as 'closed door meetings,' will most certainly set off the rumor mill. People need to know or they're left to their own imaginations — and that is always worse.

Equally important, level with people — then get the *stay versus go* decision. To address the issues in a forthright manner is no guarantee that you will keep everyone, or that everyone will believe what has been said. But to not communicate what is going on is a lack of leadership, so don't be surprised when employees don't do what you want them to.

Turnaround leaders didn't start out as such — they were often managers that worked their way up the corporate ladder through hard work and (hopefully) fair play to build a solid management reputation. They have also developed a set of skills to handle problem solving, getting results with minimal resources, (tight) cash flow management, negotiating and dealing with bankers, investors and creditors. The stakeholders will usually work with a turnaround leader — if he or she is credible.

A key initial element to a successful turnaround is to establish a good relationship with your bank. Capital is always required in tough times, not to mention that its desired in good times as well. If the leaders who were in power while the company's position was allowed to deteriorate are still there, why should the lender believe that they will *now* be instrumental in correcting the situation? With all the suspicion that can surround a troubled company, it is important that trust be re-established with the bank. Credibility with the lender(s) is mandatory to success — and most likely to keeping that cash flow at the bank. And with the bank holding the trump card, the institution must feel comfortable working with the turnaround leader. It means laying everything out on the table to keep the situation honest — and honoring commitments made to the lender.

Where consistency is important in a stable environment the name of the game in a turnaround situation is uncertainty. You can absolutely, positively count on surprises. "When it rains, it pours" may be cliched, but when applied to a troubled company, one can be sure that 'Murphy is shaking the clouds.'

(Continued on next page)

Pondering Business Change is One Thing . . . *Enduring it is Another.*

By John M. Collard

Americans are eager for change. President Bill Clinton says he's proved it. In many ways he has. But change comes hard, as the owners and founders of countless beleaguered businesses demonstrate in tough economic times.

These business leaders give credence to what one of Clinton's predecessors, John F. Kennedy, said when asked how his first 100 days was coming along. "It's very interesting," Kennedy replied. "I keep giving orders and nothing happens."

Businesses in trouble can exhibit similar or worse signs of operational paralysis. As often as not, however, management and workers are not dragging their feet. It isn't some bureaucracy refusing to take easily identified and urgently needed corrective action.

On the contrary, businesses in trouble often postpone action because their own owner-founders no longer can tolerate jarring change and an uncomfortable transition to something new. Surprisingly, some of them probably never could. Bringing in a professional who is trained in crisis abatement is simply outside their emotional comfort zones.

Turnaround practitioners are aware of this emotional dimension to corporate culture at the top. They know it to be a powerful dynamic, but they've been loath to discuss it. Though seldom fully hidden, it is tacitly off limits to any specialist who, if he or she is retained, surely will have to deal with it when nursing the ailing company back to health.

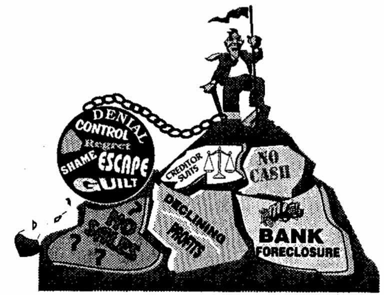
Diminishing sales, declining profits, mass employee exit, creditor suits, the threat of bank foreclosure, and no cash are only part of the equation. These problems can be repaired. The true dilemma becomes, who can handle the crisis management role? Clear thinking must prevail. The answer often resides outside the company in the form of a turnaround specialist.

In today's competitive climate, the well-meaning avoidance of any relevant aspect of a turnaround challenge is a luxury that businesses can't afford. Working with all stakeholders, on a wide array of necessary steps, can't be fully successful, or perhaps even begin, until the owner-founder can overcome their reticence to face the fundamental problem — themselves. Which sometimes means turning over the reins to a professional.

This became dramatically clear at our recent annual TMA conference, where I convened a panel of experts including a turnaround practitioner, psychologist and owner-founder, to explore this controversial behavioral phenomenon. Our psychologist and owner-president both said that denial, disbelief and anger prevent proud and talented leaders from seeking help when it's needed most.

"How could you know so much about me when we've never met?" chuckled Bob Bartlett of Midwest Polychem, Ltd., in Chicago, after following Dr. Rosemary T. Bowes to the podium at Washington's Mayflower Hotel. "Hearing you describe 'The Denial Roller Coaster,' I just went through the whole nightmare again."

The chemist said, with notable candor, he had avoided reality to the point that he was genuinely surprised when his bank expressed concerns about Polychem's financial condition. He wasn't forced to retain a turnaround or "workout" specialist, but the bank was impressed when he did. For his part, Bartlett found he could trust an outside professional who served him, not the lender.



Dr. Bowes, licensed Ph.D. psychologist, "coaches" senior executives through stressful transitions and crises as part of her private practice in Washington. Her "denial roller coaster" charts the owner-founder's emotional evolution as problems and pressures within the company intensify. "Starting at a high point, this curve will fall and rise and fall again as sadness, acknowledgment and some openings to change gradually replace denial, anger and disbelief," she explained.

She cautioned the 135 turnaround managers in the audience not to let their own emotions cloud their sense of where a client or prospective client is along the curve on any given day. "Above all," she added, "understand that being willing to change and actually enduring change are not the same. Each owner-founder responds in a different way."

Gregga J. Baxter, vice president in the New York branch of Saudi International Bank, told the audience that bankers are interested only in cash flow when observing companies in crisis. "They don't care about patents or marketing or creating jobs," he said.

Henry D. Barratt, resident partner in the Washington area office of CEO Venture Fund, explained that venture capitalists see troubled companies differently. "Unlike bankers," said Barratt, a former banker himself, "venture firms want to save the company so it'll realize the potential that warranted their initial investment." He went on to say "we talk with many consultants, but credible turnaround professionals are hard to find."

Be sure the turnaround specialist has been there before, and is not just an out-of-work CFO, become consultant. This work takes a special set of skills.

Turnaround specialists differ from consultants in that they must have an active line manager orientation. The good turnaround specialist will quickly and accurately cut through the symptoms and deal with the root causes of the problem. They will make decisions, often unlike those ever made before, to implement changes quickly, with long term implications.

Whether the unforgiving economy will prod more business leaders to embrace change remains to be learned. Given the vigilance of bankers and venture capitalists—and, increasingly, directors and shareholders—it seems clear that anything impeding high performance can put companies at risk. And what an irony that this impediment so often is emotional resistance from the person who founded the firm and loves it most.

— NCR, January 1993

Change the Leadership Style *(Continued)*

The ability to deal with change at a rapid pace is essential. This is why a seasoned practitioner can be the answer to a successful turnaround plan. The existing leadership is often 'out of its element' as it enters this untrodden ground of trouble. And when people haven't had to manage in this environment before, the odds are that they will at the very least, have a difficult time.

One alternative is to work with consultants. They can't be leaders because they can't make decisions for the company. They can make recommendations, but often to the same leader who failed to make a decision in the first place.

The practitioner, on the other hand, is a hands-on decision maker who actually takes control of the company — often as CEO — for a period of time. He is in control of the company's destiny. He must know how to be decisive, know how to isolate the problems and find solutions.

Affecting a turnaround takes an array of skills. When in crisis there is no time for a warm up. Just as with that patient in intensive care, the longer a company is on the critical list, the harder it is to nurse it back to health. To affect a rehabilitation, the right leader will know how to make the quick and proper decisions, put a plan into action and keep a talented team moving towards a healthy and more valuable end. *— NCR, May 1993*

Riding the Roller Coaster of Denial

By Rosemary T. Bowes

Every turnaround professional knows how difficult it can be to persuade a client or prospective client in crisis to acknowledge reality and accept the help that they need.

Sometimes an owner/founder will stumble along for weeks or months, convinced that events yet to occur will reveal the problem to have been a figment of the accountant's imagination. Sometimes an owner/founder will gut it out almost indefinitely, a tragic figure caught in a not-so-slow-motion nightmare.

Everyone who has observed such agonizing situations know that something's got to give, and that sooner or later something will. All roads do lead eventually to resolution. What isn't yet known is whether this inevitable resolution will be destructive in the absolute sense — a job-creating company goes under — or whether there will be a kind of "creative destruction," as economist Joseph Shumpeter put it, by way of reorganization and renewal.

Turnaround professionals waiting along these roads to resolution perhaps can be a bit more patient if they understand that the owner/founder really is in motion. No matter how stuck or immobile he appears to those around him, on the inside he is riding an emotional roller coaster. Those who would be most helpful will learn to plot the ups and downs of his path from denial to acceptance.

Denial, as psychologists define the term, means the inability to accept, process and respond to levels of information that, in other circumstances, would be sufficient to assure recognition and spur corrective action. Acceptance wins out when the weight of evidence finally overwhelms an individual's capacity for either blocking it or somehow pretending that less painful conclusions are the correct ones to be drawn.

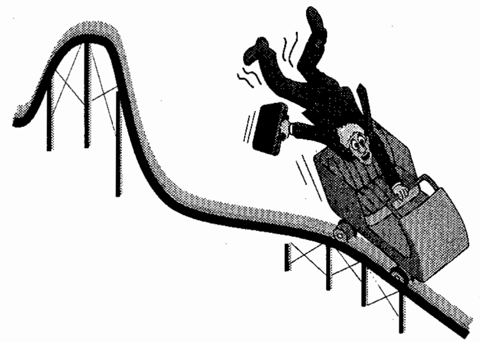
The most important thing for the turnaround professional to understand is that an owner/founder's emotional roller coaster, like the visible roller coasters at theme parks, is, overall, a downhill ride. But just as thrill-seeking visitors to theme parks are put through a series of uphill surprises along their guaranteed descent, an owner/founder working his way through denial will resist anew as negative information continues to appear.

"... a rising curve of resistance is an outward manifestation of inner denial, disbelief and anger about the situation and its origins."

Simply put, a rising curve of resistance is an outward manifestation of inner denial, disbelief and anger about the situation and its origins. The curve falls when the owner/founder experiences sadness, acceptance, and at least the beginnings of openness to change. Because everyone responds differently when under exceptional pressure, turnaround professionals should resist the temptation to project their own feelings and opinions onto the person at the eye of the storm.

Yet it surely can be helpful—both to the company and to the turnaround professional—to gain a better grasp of where an owner/founder is on his involuntary ride to reality. From an assessment of the jolts he already has sustained, one can begin to anticipate bad news yet to come, estimate how long he might take to assimilate it, and anticipate how he finally will signal his willingness to address the facts.

Assume that denial, disbelief and anger are high when you come onto the scene. After all, you wouldn't have even one foot in the picture if the crisis were not far enough advanced to suggest that it can't be handled by existing executive leadership and staff. But don't expect your presence to make things easier, at least not initially. Like that early call from the bank, or that cryptic warning from a major customer, the very thought of sharing the helm with an outsider (not to mention relinquishing it) will reinforce an owner/ founder's resistance to change.



Eventually, as trouble at the company continues to intensify, the roller coaster curve will fall again—each time for a bit longer. Yet just when this process seems complete, just when you think you can begin a decisive, constructive race against the clock and the calendar, something new will cast a shadow over your mandate: A business writer's speculative story about the company's plight . . . some revelation from the beleaguered owner/founder's private life . . . each such blip will retard the change process before hastening it.

How fast the owner/founder works through all this ego-bruising stuff, and begins to get beyond it, offers an important glimpse at "who he is" and what his best future role might be. If in the past he has successfully used denial and anger to escape from tight spots, he isn't likely to unlearn those responses soon enough to be helpful. Perhaps your most encouraging discovery would be to find, in his office, a framed copy of an old Chinese proverb: "It Is the Beginning of Wisdom to Call Things by Their Correct Names."

Be alert for off-hand comments that reveal the owner/founder's inner turmoil. Denial and disbelief may masquerade as hope ("Things will get better..."), naivete ("It can't be as bad as I'm told..."), or the Founders' Syndrome ("Only I can run this place..."). Search also for evidence of openness to change ("This job is killing me..."). Owner/founders who have supportive social relationships or other outside interests, and who naturally focus on the future, are more tolerant of change. They're more likely to finally embrace change for its opportunities. In addition, they can benefit most (because they need it least) from short-term mental health "coaching" that stresses the positive dimensions of initially unwelcome transition.

Once you've discovered where your client or prospective client is on the roller coaster ride of denial, and once you've sized up his tolerance of change, look for the right time to tactfully and sympathetically share your impressions with him. Then relax. The seeds of change have been planted. They will grow only as fast as they can.

— NCR, March 1993

Communicate in a Crisis
10 Tips for Managing Crisis Communications

By Phyllis Gillis

Ask any chief executive officer what he or she dreads most, and in all likelihood the answer will be uncertainty.

Not that senior management can predict the future. Accidents and unexpected events can and do happen. Mention corporate crisis and the words Tylenol and Bhopal spring immediately to mind, generic terms that have become classic business school case studies.

Today, as often as not, a corporate crisis is a financial crisis. More often than not, it is something that doesn't happen — from faltering manufacturing operations, gyrating stock prices, and the departure of key personnel, to the loss of a marketing partner, a slowdown in sales, or cash flow that fails to materialize.

For those who work with troubled companies, knowing how to manage communications during a turbulent time can be a powerful tool in helping set the business back on a stable course.

Increasingly, it's no longer a matter of waiting for the big one. Managing financial uncertainty has become part of the CEO's job description. While a financial crisis may be perceived as an internal condition, a troubled company's survival often depends on both its legal and finance actions, and its communications with key targets — investors, vendors, customers, employees and the press.

While specific strategies vary depending on each individual situation, there are guidelines for meeting the challenge of a financial crisis:

1.) Organize a crisis management team. Usually the signals that a crisis is brewing begin to surface well in advance of the eruption; for instance, excessively delayed contracts or marketing agreements, a bleeding balance sheet or large numbers of product returns. Building familiarity among the company's advisors early, specifically lawyers, accountants and communications counsel, encourages trust, chemistry, and an awareness of each advisor's skills and capabilities before the parties are thrown together within a crisis environment.

2.) Draft a short mission statement. Once the team has been organized, a brief mission statement should be drafted which outlines the goals for the communications effort. This statement is critical in building consensus among the team members over the future course of action.

3.) Conduct a crisis audit. Some financial crises may be anticipated; others may be out of the company's direct control. By playing out the scenarios likely to occur if specific financial strategies do not materialize, for instance, development of a marketing partner, undertaking a public offering, or raising venture capital, crisis planning can help focus the impact upon a company's business and marketing strategies. It can also indicate where the communications efforts should be directed. This audit can also identify target publics likely to be affected; for instance, investors, shareholders, vendors, employees, and customers,

4.) Develop a crisis communications plan. Turnaround managers are accustomed to the unexpected. Many senior executives are not. Crisis anxiety can be minimized by developing a plan that outlines the potential life cycle of the crisis or business setback and the steps and actions to be taken at each point in the cycle. The plan should also identify the key themes and messages to be conveyed to target audiences and the methods for reaching them.

5.) Tell the truth. When a financial crisis strikes, don't hide behind legal jargon, a set of numbers, or engage in finger-pointing. Put a public face on the problem, specifically the CEO's, and meet with key target publics to explain the problem and what management intends to do about it. Follow through on realistic milestones and promises to rebuild credibility. Better to promise quarterly updates and meet them than to create more ambitious expectations and fail.

6.) Keep the story simple. Keep your internal and external communications simple, direct, and frequent so that everyone is kept informed of your progress. Tell your target publics what you are going to do, do it, and then tell them how you've done it. Forthright disclosure is essential. This is the time for the lawyers and the communications team to work together, not to stonewall the problem.

7.) Identify remedial actions or redress and communicate progress on a regular basis. Let your target audiences know that you are taking immediate action to redress wrongs or rectify problems. Case studies or humanized actions can help build support during a crisis. These tactics can also help interest the media in putting a positive spin on your efforts to resolve the crisis and encourage involvement in the long-term solution.

"...Knowing how to manage communications during a turbulent time can be a powerful tool in helping set the business back on a stable course."

8.) Evaluate feedback and modify the communications plan if necessary. Flexibility is essential in any crisis situation. Keep your eyes and your ears open for response. Is your message getting through? Is the media playing your story accurately? Are your target audiences responding appropriately? If your plan isn't working, don't be afraid to change or adjust it.

9.) Keep the lines of communication open. In a crisis situation control is essential, but a narrow management perspective often blurs alternate views. Non-management employees or staff may offer valuable insights into alternative courses of action. Encouraging suggestions from the bottom up also helps keep interest and involvement high among audiences that have a stake in the outcome of the crsis, but little into into the decision-making process. Keeping the lines of communications open may result in a fresh perspective toward the solution of a problem.

10.) Build on a short-term crisis plan with a long-term proactive communications strategy. Nothing builds interest and involvement like awareness and knowledge. The more your target publics know about you, the more likely they are to want to do business with you. Keeping your audiences informed builds interest and involvement. This translates into knowledge and awareness about a company, its products and services, and a business's growth and development. A well-planned and skillfully implemented strategic communications program can be a powerful tool for turnaround success.

The time to prepare for a crisis is before it happens. The key is being alert to potential problems and planning for the inevitable. Engaging in communications risk management can help minimize disruption to a business and its bottom line and help the turnaround manager guide his clients back to business as usual.

— NCR, July 1993

Winning Through Negotiation

How to Get What You Need at the Bargaining Table

By Richard J. Walters

Negotiating is one of the most difficult, yet beneficial skills turnaround professionals can provide. Troubled companies have a litany of problems with customers, suppliers, lenders, investors and employees. As a turnaround professional you will be immediately thrust into emotionally charged, time-limited and economically significant negotiating situations.

Negotiating is a learned skill that improves with practice. Negotiating is an art form and *everything is negotiable*. We feel most comfortable when we have full knowledge, make ultimate decisions, operate on our own turf, and have unlimited time to consider alternatives, but turnaround situations do not afford these luxuries. Your ability to effectively recognize, adapt and control adverse situations will determine your ultimate success as an able negotiator.

Successful negotiators share some general characteristics. They exhibit good business judgment, an understanding of human nature, confidence and they are good listeners. They are able to be patient and tolerant in conflicting and ambiguous situations, all the while asking questions and taking calculated risks to accomplish superior solutions. Good negotiators believe a cooperative exchange benefits all parties. In the end, a good negotiator can leave all parties feeling comfortable and satisfied.

But there is another type of negotiator, the "winner takes all" type negotiator. This person appears as a wolf in sheep's clothing and their strategy is "hit and run" — with your hide. You usually sense that kind of person with "gut radar" — that tight knot in the pit of your stomach and your instinctive counting of fingers after the handshake. Your safest course of action is to walk away immediately. If negotiation is the only recourse you must skillfully switch this *win-lose* competition to a collaborative negotiation with acceptable gains for both parties.

Keeping the Ball in Play

It's always important to keep open negotiations ongoing. If both sides are talking that means there is mutual interest in resolving the existing situation. The more time and energy each side invests, the more difficult it becomes for either side to give up. In corporate America it's often easier to explain a poor settlement than an aborted negotiation.

One of the most sensitive elements during negotiations is time, and the timing of deadlines. In a turnaround situation, the troubled company is under enormous financial pressures and time limitations. This very weakness can provide positive negotiating leverage.

For example, the bank calls to collect the late payment on its loan. You reply, "I'm pleased you called. We need to schedule a meeting to bring you up to date. Unfortunately, our financial condition has deteriorated dramatically. We are in a severe cash flow crisis. In fact, we're currently considering filing for chapter 11. Our only chance to avoid filing is for you to drop out interest rate to prime-plus-one-percent and defer payments on the principal for at least a year."

You now have the loan officer's undivided attention. He or she has a boss to advise and an internal time deadline to resolve *your* problem. The very weakness of the company undercuts the bank's power and bargaining ability.

NEGOTIATING CHECKLIST:

- ✔ Be a good listener
- ✔ Get, not give, information first
- ✔ Keep negotiations ongoing
- ✔ Answer questions with questions
- ✔ Look for motivation
- ✔ Build relationship with counterpart
- ✔ Be humble, ordinary, likeable
- ✔ Always congratulate the other side in victory - especially when it's yours.

Asking the Right Questions

The effective turnaround professional begins seeking information from the first contact with a company. The primary task is to gain as much information as possible while giving up as little as practical. Ideally, in the case above, the turnaround professional would have initiated an earlier meeting to gain information and set expectations before the crisis call. The best and most useful answers often come months before you reach the negotiating table.

You gain knowledge by asking questions. People are conditioned to answer automatically. Begin with fact finding questions. "Who?" "What?" "When?" "Where?" "How?" and "Why?" Ask several questions where you already know the answer to calibrate the credibility of the individual. Mix in direct questions like "How can we solve this problem?" As the conversation develops add opinion seeking questions like "Do you think?" "Is it reasonable?" "Can we agree?"

If you have caught the person's attention, you will be asked questions in return. Answer with questions in a non-offensive way. Use softening statements like "That's a good point, How important is our business?" Or "I'm glad you asked me that. If you were me, what would you do?"

Smart is Dumb; Dumb is Smart

In information gathering, as well as negotiating, it isn't always smart to be brilliant, decisive, fully informed, quick or totally rational. You'll learn more and possibly win greater concessions if you are occasionally slower to understand, slightly less decisive, or maybe a little irrational. Be sincere and interested, never arrogant. Ask for clarification, say "I missed that" or "I don't understand." Answer a question with "I don't know, I haven't had time to look into it yet. Do you believe it's important?"

Initial questions rarely reflect the *real* information being sought. Don't give away information needlessly until you understand true intent. Start with "Interesting question, why do you ask?" Followed by "That makes sense, can I ask why that's important to you?" Then possibly "O.K. right, So? By the third response you will receive an unrehearsed emotional response of true intent.

It is important to understand the emotional process because people make judgments, develop their real needs and negotiate based on emotions, not intellect. They'll rationalize the facts and final result. Think about the last new car you purchased. It's basic transportation, right?

Effective questioning is the *single* most difficult tactic for the young or inexperienced negotiator to master. High intelligence and ego are difficult to manage and contain. Some turnaround professionals think it is important to have unbounded expertise, ready opinions and look good at all times. This severely limits their effectiveness. My father dispensed business knowledge in homey sayings.

His best advice: "God's wisdom was two ears and one mouth. Listen twice as much as you talk."

Success is a Result, Not a Goal

People negotiate when they believe they have something to gain. The secret to a successful negotiation is to find out what they need and show them how to accomplish it while you are getting what you want.

There are two types of needs; the issues and demands they openly discuss and their covert, *real* needs. Show why your proposed solution has immediate relevance and value that meets their *real* needs.

(Continued on next page)

Improving Your Negotiating Skills *(Continued)*

As you prepare, postulate and develop the other side's *real* needs, risk profile and willingness to reach an agreement. Try putting yourself in their shoes. Cautiously try out your assumptions as the negotiations proceed. Remember, they're only assumptions, be willing to rethink and modify your tactics accordingly.

Undertake face-to-face negotiations in a nonconfrontational, positive manner. Your approach should be more like velvet and never like burlap; you'll get to conflict soon enough.

Begin by seeking an overall agreement on a statement of the common problem. You might begin by saying, "Can we agree on why we are here? We have a mutual problem. We need to fashion a fair and equitable solution that is acceptable to both our companies."

Encourage the other side to fully express their view of the problem. Be an attentive and thoughtful listener. Being attentive is the easiest and least costly concession you'll give. Don't interrupt. Make notes, when appropriate. They will be useful when you take the lead to draft the final agreement. Restate and summarize their position and objectives and ask for their agreement. It signals understanding. The better you pay attention the longer they'll talk, redefine and amplify their position. There may be a nugget of *real* need or a new alternative solution offered.

Listen for unintentional speech patterns. When the speaker increases his delivery speed or becomes increasingly "big picture" in his arguments it's a good time to ask detailed questions. The underlying support and logic are probably weak. Usually, the louder and more belligerent the individual, the weaker the position. Refuse to be intimidated. Respond with quiet, yet firm, facts. Leave emotions in the other room. Never cause the other party to "lose face" in front of peers through ridicule or humiliation. They will attempt to get even to the mutual detriment of all involved.

A final settlement is easier reached if the starting points give ample room to accomplish your objective. Don't be in a hurry to bring up your strongest points and power. If possible, it's better to understand the other side's full viewpoint before expressing yours. In addition you'll be better able to phrase your points in terms of their understanding. Identify the key points and concentrate on solving each one individually. *There are seldom more than three major issues involved in reaching a successful conclusion.*

Never accept the first offer. Tackle the easier issues first. If you reach an impasse set that issue aside and move forward to the next. Don't give a concession without one in return. Concede slowly and always identify a concession whether major or insignificant. Keep track of your concessions for bargaining leverage and exchange unequal value whenever possible. Employ the Pareto Principle in negotiating: Only 20 percent of the time will be spent on issues that represent 80 percent of the value. The most significant concessions will come at the end of the negotiations, keep some "giveaways" in reserve.

Don't make the first concession on your major issues, especially money. The increments on money concessions are very important and can send either a positive or negative strength perception. If you deadlock it is most likely over money. Consider changing the shape of the payments to increase their time value. It usually starts conversation flowing again. What's important is to have each side caucus with their team and organizations. New alternatives may be developed or old ones reexamined. At this late stage both sides are under increasing pressure to find an equitable solution. Remember you are a professional solving a difficult problem. You care but life goes on. Stay objective, contain everyone's emotions and be patient but persistent.

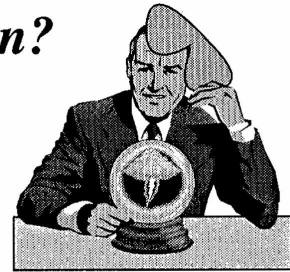
Develop a personal and emotional bond with your direct counterpart. Work hard to be an ordinary, likeable indi- vidual with feelings and needs that the other person can identify with and feel obliged to help. Negotiate as yourself representing the company. People are creatures of habit that identify with both friends and opponents. You're in the home stretch. You might say "We've come a long way together. I need you to consider making this final concession as a favor to me." Or "I thought you and I had agreed on this? You're not going to let me down on this? Are you?" Watch your timing; there's an implied reciprocal agreement involved.

Patience is the most powerful tactic in a negotiation. It allows both sides to become comfortable with each other's position. It takes time to understand issues; weigh risks, test the other side's strength and weaknesses; know what your opponent really wants; and change their expectations. Organizations need time to reconcile their desires with the realities possible.

When you have successfully accomplished everything you had originally planned, be gracious. Always declare the other side the winner, an able negotiator and thank that person for the opportunity to work together. That's the mark of a negotiating professional.

—NCR, November 1993

From Here To . . . Where? What is Your Mission?



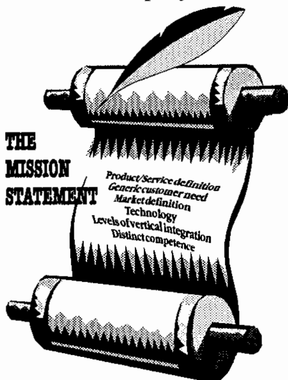
By John M. Collard

With the revelation that the company is in trouble and has no cash, there is a mad scramble to figure out why. How did we get here? Often, the focus of the management team was aimed in the wrong direction. Perhaps better stated, the company was allowed to proceed with no direction at all. There was no mission to guide the operation.

As trouble solidifies, it takes awhile to erode the equity. During this period, there is an absence of direction, camouflaged by a flurry of activity and the illusion that management knows where the company is going.

Once in crisis, the immediate reaction is to 'stop the hemorrhaging,' cut costs, reorganize the balance sheet, hold the creditors at bay, buy time to work things out. In crisis, these tactics are necessary and mandatory for survival, *But what then?*

Stabilization tactics are often short term in nature. What happens when the crisis consultant is through with his work? Consultants, that concentrate on crisis alone, frequently don't address the real need; to rebuild the company so that it can stand on its own feet for the long haul.



Why? Sometimes the driving force doesn't allow time . . . if it's the bank or lender, they want to recover their investment . . . if it's avoidance of potential litigation, this is akin to cutting one's losses. You can think of other equally limiting situations.

For the company to be truly viable, it must build a solid management team that is able to generate revenues, control costs, manage bank and customer relations. But Wait! Wait! Wait! This is just . . . There you go — again? All of this 'stuff' is great, but it sounds like the same old spiel. The real question is, *Where are you going? What is your Mission?*

When this question wasn't adequately answered in the first place, the company was off to a bad start. The management team may have signed a death warrant, without knowing it. When the 'rudder' is left untended, only fate can guide the course of the company, and usually you will end up on 'troubles reef,' wondering why.

Consider a novel idea, take the blinders off, set a course with a high degree of probability of successful accomplish- ment, within allotted time frames, and stick to it. Setting such a course is an arduous task. It means work . . . and a lot of it. It means risk . . . someone, the leadership, needs to state which direction the company is to go in. Yes, you must make a decision, and more importantly, have the conviction to follow it, and convince others as well. But which course, and how?

Why not consider a statement of your mission? NASA did when it sent man to the moon. Why? Because it was important to bring him back. That mission states . . . send a manned vehicle through space to arrive at, land on the moon, and then bring him and it back to Earth.

To some this was a 'crazy' idea, but now an American flag flies on the moon's surface. Incredible. . . mission accomplished.

When a besieged company faces the abyss, is the challenge any greater? To those who have to overcome that challenge, it is on par with those who can send and recover man, and his objects, from space.

(Continued on next page)

The Elements of A Mission Statement

Product/Service Definition — What do we do or provide? We will offer *(specific products/services)* **that are positioned to** *(special benefit to be gained)* **and will be focused at** *(definition by line, scope, or positioning).*

Products and services should be defined in terms of how they are positioned to serve and benefit the customer. Include breadth of product line, attributes, price, quality level, product classification, and so on. How will you contribute to fulfilling the customer's mission? Limit the extent of the offering to focus on what you do very well.

Technology — How will we deliver our services? We will use *(define technologies to be utilized)* **to provide our services.**

Choose which technologies, or combination thereof, you understand and are capable of offering; this is critical to setting an effective business development strategy. Here is where you begin to set the company's product apart from the competition, and from areas of business where you don't belong. Actually providing an array of multiple technologies can involve increased investment, and a risk of diluting effectiveness, commitment, and impact. Conversely, complimentary technologies can allow skill sharing economies of scale, controlled flexibility, and unique benefit to your customers.

Levels of Vertical Integration — How much will we do? We will provide *(stages in the life cycle offering)* **designed to support** *(degree of penetration to satisfy the customer's entire need).* You can't be all things to all people, resources will not allow it, not to mention, it's just plain not good business sense.

Define which elements of the customer's requirement will, and will not, be satisfied. This effort will indicate where you need to develop new products, seek partners, or avoid competing. Plan how products and services will support changing customer dynamics, and how you will stay abreast.

Generic Customer Need — Why will they buy? Our products and services will satisfy *(what important customer demand or necessity).*

What is the customer trying to accomplish? By defining generic needs versus 'today hurts,' you can identify future growth directions which have a higher probability of being funded and carried out. If the need is greater than you can currently offer, you clearly define areas where you may want to augment capabilities, or where strategic alliances may be necessary.

Statement of Direction or Market Definition — Who will we sell to? Where are they located? Our main thrust will be dedicated to the *(market definition or segmentation).*

The key here is to focus on who you are, and as importantly, are not, going to aim your efforts at marketing. Define the scope of the market. Which specific customer groups or segments and geographic territory will be served or not served? This section enables the development of different strategies necessary to address multiple directions, yet accommodate your common goals.

Distinct Competencies — Why will they buy from us? We will develop and maintain unequivocal qualifications in *(which areas),* **which will yield** *(specific capabilities).* **We commit to** *(level of expertise to set us apart)* **to remain recognized as an expert in** *(what we do better than anyone else).*

Define and focus on those special abilities which set you apart from the masses. Competencies will command the higher profit and cash flow margins. This is the most important thinking of all. What do you accomplish that the competition cannot? What areas do you need to invest in, to maintain your advantage? Address the level to which the distinct competence *will differentiate you, and be recognized by the customer.* Discuss how to bring these competencies to the customers attention.

Turnaround Leaders Predict More Business Failures in 1993

Leaders in the turnaround community are predicting an increase in business failures for most regions of the U.S. for 1993.

Failures are likely across a wide variety of industries due to tight credit, weak demand, and a definite uncertainty of what to expect with the new administration. Industries most likely to suffer are:

- **Defense** — due to reduced government spending in this area, excess capacity, and the difficulty companies will have moving technology to new markets.
- **Real Estate and Construction** — due to overbuilding and a lack of investment funds available.
- **Retail, Distribution, Capital Goods, and Consumer Products** — due to tight credit and sluggish consumer demand, even in light of recent signs of increased buying.
- **Manufacturing** — due to declines in automotive, defense, and consumer spending.

Over 39% of 2,823 manufacturing companies reported losses last year. Of 1,168 publicly traded service companies, once believed resistant to economic downturns, over 43% reported losses.

Over 41% of publicly traded wholesale, and 34% of retail businesses reported losses as well. "When you have this number of companies posting losses coupled with a slow or stubborn recovery, failures are likely to continue to increase," said Hass.

William J. Hass, a partner at Ernst & Young, Chicago said "Red ink has been flowing at many businesses over the last two years."

"Combine this with the slow pace, or lack of recovery in many industries, which has weakened many balance sheets, and you cause risk adverse lenders to become extremely nervous."

Hass has coordinated a national survey of turnaround managers and industry leaders, the response from 140 to date reveals some interesting findings. The survey questions were aimed at determining views of the impact of the Clinton administration, the credit crunch, management behavior during crisis, and where to expect activity during 1993.

Will structural changes cause more layoffs and job uncertainty and reduce chances of recovery in 1993? An overwhelming 75% responded yes, and also indicated that the economy will not be turned until late 1993 or into 1994.

What impact will Clinton's actions have? To end the recession, Clinton must reduce lending constraints on banks and admit that the problem is very serious and will take time and pain. The recession could be prolonged if Clinton increases taxes or if the banking crisis continues.

What is the impact of the credit crunch? The survey responses predict that this recession will have a greater toll than the last one. This is due to the preponderance of debt and the broad number of industries affected at the same time.

What is the importance of management action? The most important consideration when facing a crisis is to recognize and admit a problem exists early enough to take action. To avoid the crisis, management must develop a plan to avoid chances of occurrence.

The key is to overcome management denial that a crisis exists. Graphically display and discuss alternative scenarios, this is a delicate issue.

The survey also indicated that half of those polled would be involved with companies in the Northeast and Mid-Atlantic regions during 1993. In addition, a troubled company can typically expect to reduce headcount by more than 15% in 50% of the cases, and by more than 10% in another 25%.

According to Richard Wirth, president of The Corporate Renewal Services Group, "There are a large number of companies who have managed to survive recently, but many managers still haven't learned how to operate in today's no or low growth environment. These companies no longer meet the tougher credit standard demanded by many banks, and are likely to fail as margins continue to fail."

Jack Stone, partner at Pate, Winters & Stone, predicts a "continued domino effect" caused by credit tightness, uncertainty about layoffs, the slow economy and the number of highly leveraged companies that are still struggling." We are not out of the woods yet, it seems.

Norman Wolfe, president of Bingham Wolfe Corporation, believes that we have just begun the process of consolidation in many industries. "In California, further decline in the defense and real estate industries will affect scores of support businesses. There is an exodus from the state that is likely to have a ripple effect."

"While California is in a deep trough, it may only get worse in aerospace, printing and retail industries," said Roger Scadron, Vice President, at Congress Financial Corporation.

The restructuring of corporate America is occurring before our eyes. Companies that fail to respond to execute the changes necessary to survive will most certainly fail; or as an unpleasant alternative may be acquired by more successful competitors.

— *NCR, January 1993*

From Here To . . . Where? *(Continued)*

Resources are often scarce, or nonexistent. Direction . . . the focus . . . is in serious question. Why not learn from those who have succeeded?

The role of the mission statement is to identify and provide the planning team, management, employees, customers — all stakeholders with an understanding of future growth directions. It is a conceptualization, based on an appraisal of strategic alternatives. It provides an overview of the concepts of the business scope and direction, and furnishes a guideline for achievements in winning new business.

Some consider the process of developing a statement of mission to establish direction to be extremely complex. Contrary to popular belief, the process is multidimensional, and is really quite simple when you break it down into components. The difficulty lies in the execution. What is a mission? Why is it needed? Webster says "... a continuing task that one is destined or specially called upon to undertake ...," which implies direction, with a conviction. What's involved? What will produce the desired results?

The *Statement of the Mission* is an amalgamation of six components that will guide the company in a specific direction. Whether this direction is toward recovery depends on the thought process and preparation. With proper thought the company can often be saved. On the other hand, the 'lick and a promise approach,' is still available.

Lets look at a template of how to build a corporate Mission Statement. *You* fill in the blanks where the print in italics exists.

Our mission is to provide *(Specific Market Segments)* **with** *(Some Product or Service)* **because the** *(Customer Need)* **can be satisfied.** This begins to say something. It begins to address the needs of the customer, why he buys, when, and where he buys. Now we're getting somewhere.

Only after developing a comprehensive matrix describing the relationship of these six elements, for each product or service that you offer, will you have properly completed your work. Surprise! You have a statement of direction that has substance; one that, if executed, can produce added value for the company. Some believe that developing a mission statement is the first step in the strategic planning process, some believe it to be the last, while others ignore both altogether. Running a company without proper focus is a lot like driving while wearing a blindfold . . . in either case you are predestined to 'an abrupt end.' —*NCR, March 1993*

Are You Ready for Reengineering?

By Carolyn Davis Cockey

There's a structural change underway that will transform the way businesses function today, and perhaps forever. The 90s promise to bring a decade of radical change, and at the heart of that change is the concept of corporate reengineering.

Mass media would have you believe that corporations adopt new management styles almost as often as Tom Peters publishes a new column, but companies have been slow to change. Remember teaming? Remember searching for excellence? Remember thriving in chaos? Most analysts would argue that these concepts were a lot about boardroom noise but actually had very little to do with lasting, dramatic change.

In fact, most companies today find themselves doing business in a style that has been with us since the 1700s. Most blue and white collar workers report in every day to churn through specialized tasks that, when married with the efforts of their coworkers, produce a saleable product or service.

Change for change's sake is not always good, although companies were quick to herald the merits of change when the country plunged into recession several years ago. And while change is lurking on the horizon, this time it's not for the sake of downsizing, or for the sake of economic concerns or to adapt to the latest management whim.

This time, change is being driven by two powerful forces that, when combined, will transform business on both local and global scales. This time, rapidly developing technology and the need to survive under intense and increased competition is forcing change.

"There is a major change underway for corporations in that they are actively seeking to operate with greater efficiency and that is being perceived as a sea change that ought to last for at least the next decade, if not two," says Sam Davy, a retired affiliate with Arthur D. Little in Cambridge, Mass. and a board member of the Turnaround Management Association's (TMA) New England Chapter.

A LOOK AT REENGINEERING:

WHAT IT IS:

1. A technology-driven work process
2. The reorganization of processes around constant change
3. Combining several jobs into one
4. The logical reordering of work with an emphasis on team effort
5. A move toward accountability with fewer checks and controls

WHAT IT'S NOT:

1. An excuse for downsizing
2. Automating every process for automation's sake
3. Starting from scratch
4. The relayering of management structures
5. A passing trend

Hence, reengineering. Because reengineering isn't about tasks and jobs and organizational structures. Reengineering is about processes. It's about scrapping current ways of doing business and retooling from the bottom up with an emphasis on increased efficiency, and the successful use of the technology at hand.

"If your company is to survive and succeed in today's highly competitive business world, you can't settle for incremental improvements," say authors Michael Hammer and James Champy in their new book just released this summer, "Reengineering the Corporation".

"Forget about tinkering with your company's organizational chart, job descriptions, or machinery. Instead, prepare to challenge — and in some cases, abandon — fundamental assumptions about how your company does work."

For example, the authors demonstrate, six years ago Kodak found itself watching as its competitor, Fuji, announced a new, single-use, pre-loaded camera — the kind of throw-away camera most people pick up today at convenience stores for less than $10. As Hammer and Champy put it, Kodak had no product similar to Fuji's, and with its existing design processes, it couldn't even dream of bringing one to market in less than 87 weeks — or one and one-third years after Fuji had entered the market.

Reengineering Checklist:

1. **Focus on business practices -** Throw the baby out with the bathwater. It's time to concentrate on a whole new baby.
2. **Aim high -** Don't settle for the easy path and don't be afraid to change direction.
3. **Anticipate resistance -** Decide now how you are going to handle the criticism and attempts to thwart change.
4. **Follow up -** And communicate to death.

Rather than panic and scramble, executives at Kodak had the insight to stand back and take a long, hard look at its design process. They also reached out to embrace the latest in Computer-Aided Design/ Computer-Aided Manufacturing (CAD/CAM), something the authors said would become the cornerstone of their reengineered design process.

The new technology took the designers from their drafting tables — where revisions had to be done by hand — to computers. Instant access to immediate design changes meant anyone who had involvement with the design process was kept constantly up to date. Conflicts were resolved in minutes, rather than months, and Kodak brought its camera to market in nearly half the time, and at 75 percent of what it would have cost under the former design scenario.

And so goes Kodak's success with reengineering, a success that has been shared by other companies such as Taco Bell, Hallmark Inc., General Motors, Ford Motor Co., IBM, Hewlett-Packard, and Proctor & Gamble Inc., to name a few.

While those companies' individual successes with reengineering have been well-documented, only a handful of forward-thinking CEOs are starting to wake up and get interested in the process, experts say.

"A few companies have a good understanding of reengineering. Motorola has been practicing it for years. And I believe that reengineering and renewal are words that are going to broaden in understanding and aware- ness as more companies get involved with the dramatic changes that are going to take place during this decade," says Bill Hass, TMA vice-chairman and a partner in Ernst & Young's Chicago operations.

Hass says reengineering is more than just the latest in corporate buzz-words. Reengineering can bring dramatic and lasting changes.

"It demonstrates the need for continually reinventing the business concept and challenging the very concept of business. But you have to do more than that with reengineering. You have to actually do something about it, as well," he says.

(Continued on next page)

THE REENGINEERS

Here are executive and worker roles:

Leader — Authorizes and motivates overall effort. This person should have the clout and passion to see the process through to the end.

Process Owner — This typically senior-level person is assigned to the process and builds the team. He or she should have clout and the ability to run interference for the team.

Reegineering Team — This group is comprised of five to ten individuals who examine the existing process and oversee its redesign and implementation. The team needs to consist of insiders and "outsiders" so that all perspectives are brought to the table. One word of caution: each team is assigned only one process at a time to ensure success.

Czar — This is the cheerleader that supports the process owners. Additionally, this person coordinates all reengineering activities and helps new process owners understand the company's reengineering techniques.

Source: Reengineering the Corporation, by Michal Hammer and James Champy

Recent Developments...

By Wendell H. Adair

Three unrelated recent legal developments provide interesting planning opportunities for turnaround practitioners. They include provisions of the Revenue Reconciliation Act of 1993 (the "1993 Tax Act"), a California asbestos case and an IRS deferred compensation letter ruling.

The 1993 Tax Act

Although the recently-signed 1993 Tax Act contains a number of provisions affecting all individuals and corporations, there are two that may be of particular interest.

The first pertains to the so-called stock-for-debt exception discussed in TMA's last newsletter. Under current law, corporations that issue stock to their creditors in satisfaction of debt recognize cancellation of debt ("COD") income to the extent the debt satisfied exceeds the fair market value of the stock. Although corporations that are either bankrupt or insolvent can exclude COD income from taxable income, they must reduce their tax attributes (i.e., NOL carryovers, asset basis, etc.) by the amount of the excluded income. Under the stock-for-debt exception, however, bankrupt or insolvent corporations that issue stock to creditors and meet certain other requirements are not required to recognize the COD income otherwise attributable to the exchange nor are they required to reduce their tax attributes.

As a result of an intense lobbying campaign involving many TMA members, the provisions of the 1993 Tax Act repealing the stock-for-debt exception will not become effective until January 1, 1995. Simply put, bankrupt or insolvent corporations issuing stock to creditors in satisfaction of debt after December 31, 1994 will be required to reduce their tax attributes by the amount of COD income excluded from taxable income. However, the repeal does not apply to stock issued to creditors after December 31, 1994, if pursuant to a bankruptcy action filed on or before December 31, 1993. This would suggest that there may be a premium to a corporation otherwise considering bankruptcy to file before the end of this year.

The other provision of the 1993 Tax Act of particular interest to practitioners pertains to the recognition of COD income on certain indebtedness secured by real estate. Under the 1993 Tax Act, a taxpayer (other than a C corporation) can elect to exclude from gross income COD income attributable to the discharge of "qualified real property indebtedness" ("QRPI"). QRPI is debt (1) incurred or assumed in connection with real property used in a trade or business, (2) that is secured by that real property, and (3) with respect to which the taxpayer has made an election under this provision. The amount excluded under this provision cannot exceed the taxpayer's basis in the property and is treated as a reduction in the basis of the property. Certain other limitations also apply. The provision is generally effective with respect to discharges after December 31, 1992 (i.e., it is retroactive to the first of the year).

Tenant Liability

A very recent California case held that a tenant is required to pay asbestos abatement costs even though the presence of the asbestos materials at the premises pre-existed the lease and the tenant was not aware of its presence at the time the lease was executed. The Court's reasoning was that the tenant was liable for abatement costs under a "compliance with all laws" provision in a "standard" form commercial lease.

Given this precedent, when representing a tenant, at a minimum, practitioners should consider specifically excepting out abatement costs as a tenant's obligation, or better yet, carving out from tenant's liability all costs relating to pre-existing conditions.

Deferred Compensation

A recent IRS private letter ruling may present deferred compensation planning opportunities for executives of both publicly and privately held companies. The ruling allows an executive to secure payment of deferred compensation and non-qualified supplemental retirement benefits without subjecting the deferred compensation or supplemental benefits to current tax. The ruling could not have come at a better time, given the new tax act which further limits the amount of benefits that can be provided to highly paid employees under tax-qualified retirement plans, and thus will undoubtedly result in increased interest in unsecured executive deferred compensation and supplemental pension benefits.

In the past a number of devices have been used to secure the payment of deferred compensation and supplemental pension benefits. The most widely used of these devices, the rabbi trust, protects against losses resulting from a change of control or a change in management. However, until this latest ruling, there was no device that retained the tax deferral and provided protection in the case of the employer's insolvency.

Now, the IRS has ruled that an executive can purchase from an independent company a policy that insures the payment of deferred compensation or supplemental benefits even in the case of employer insolvency. The ruling also states that the employer can reimburse the executive for the policy premium, provided the reimbursement is treated as taxable wages to the executive. The importance of this ruling is that the purchase of the insurance policy will not cause the deferred compensation or supplemental retirement benefits to become taxable earlier than they would otherwise become taxable when paid to the executive by the employer. Thus, the act of insuring the payment of the non-qualified benefit would not destroy the tax deferral.

— *NCR, September 1993*

Ready for Reengineering? *(Continued)*

What Kodak did to bring successful change was to effectively use technology, observers say. That move, Hammer and Champy say, is nothing less than the undoing of the industrial revolution that has shaped business for the past 100-plus years.

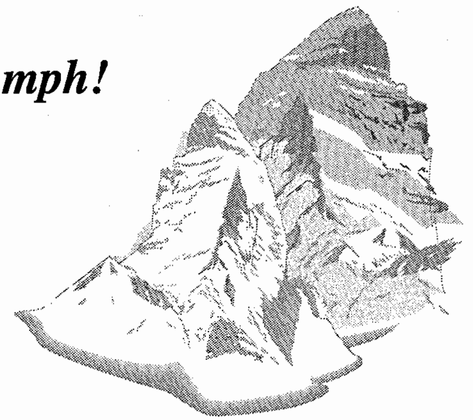
Work is no longer task-driven, but process-driven. At the Wharton School of Business, reengineering is now part of a required course, says Thomas Gerrity, dean of the school. The way Wharton is teaching it: You integrate ideas and technology that are both forthcoming with those that have been around for years and you do all tasks through new processes - simultaneously. Which is not unlike what Kodak did in manufacturing camera prototypes while designers were still tinkering with the mechanism itself.

What businesses hope to gain through reengineering, experts say, is the opportunity to increase productivity and efficiency, maximize opportunities to compete both locally and globally, and finally, reap all of the financial and manufacturing benefits from investments into technology and automation.

But not all companies will be successful with reengineering for a number of reasons: reluctant middle managers will be slow to adapt out of fear of losing their jobs during the flattening of corporate tiers that reengineering brings about and CEOs may or may not have the intestinal fortitude to shake the company from the bottom up for the one-plus years that true reengineering takes. Lastly, reengineering is about exhausting ideas — companies may or may not invest the time and money it takes to allow both in-house and outside consultants to bring all perspectives to the table. —*NCR, November 1993*

Musings From The Mountain

Set Your Priorities, Renew Enthusiasm and Triumph!



By John M. Collard and Richard J. Walters

It is important to take time to reflect on your priorities . . . in life, health and business. For our personal well being; we retreat to the mountains, the shore or some hide-a-way to rejuvenate and gain a renewed perspective on life. In business take a similar approach; step back, evaluate and organize; it will make a big difference. ***Even seemingly insurmountable goals can be brought into proper perspective if you organize and prioritize into a handful of manageable tasks and execute zealously.***

The company in crisis, or seeking renewal, is a prime example where concen- trating on and re-examining priorities can make **the** difference between success or failure in the months and years to come. When you approach priorities in a diacritic sequence and with the proper intensity, the outcome can be extremely favorable. On the other hand, when tasks are undertaken in an event driven, interrupt mode, the outcome is unpredictable and often falls on the side of failure.

Strengthen The Cash Position. The Cardinal Rule is . . . when you are out of cash you are out of options. Subsequent priorities are meaningless, not to mention a waste of time and energy. Is there sufficient cash? Where is it coming from? Is the source reliable and forecastable with some degree of accuracy? Can you sell assets (inventory, receivables, equipment, divisions or subsidiaries, etc.) to generate cash? How much is needed to survive, to get well? How quickly can cash be generated from sales? Build cash reserves . . . to keep the company moving in the right direction, additional cash is needed to fuel growth.

"...There are no unrealistic goals, only unrealistic time frames..."

Obviously, a cash flow forecast is crucial, it should be a model that encompasses the critical variables. The real virtue in such a model is the relational aspects of the variables or the parametrics, that can forecast what may happen with a high degree of probability. Remember, cash is used for many needs that are not reported on the income statement; look to the balance sheet and be sure to consider all sources and uses when forecasting.

Rebuild The People Element. Normally by this time key employees have left the company. The most valuable intangible assets are now diminished. You must operate with those that remain and fashion them into a cohesive team. Develop these dedicated employees to expand their skill-sets because they will become your key replacements. Motivation is paramount. You can augment the on site team, but in the end the value in the company will be tied largely to the employees that make the company run. The more finely tuned the team, the greater goodwill value will be placed on the company.

People are your most important and adaptable asset. Given a choice, you are better served when you have 'A' class people and 'B' class product . . . and not vice versa. Impart the vision, goals and timeframes, make sure employees understand, then move out of the way and let them surprise you with their results. They will step up and do more, given the opportunity.

People are the most challenging asset to manage. They are influenced by many forces. They are affected by events (controlled or otherwise) . . those at home who are uninformed . . . others around them . . . what they don't know . . . and scarier yet, what they imagine. The best way to deal with these phenomenon is to communicate clearly and often with the work force — at all levels and be honest. When they believe the message is fair, they will respect the communication. Albeit, they may not like what is being said or what is going on in the company; they will respect the source and make their decisions accordingly. You can influence, but you can't change their final decision to stay or go.

> Prioritize into a handful of manageable tasks and execute zealously:
>
> - Strengthen the cash position.
> - Rebuild the people element.
> - Establish leadership.
> - Put a plan in place.
> - Communicate with all stakeholeders.
> - Execute a marketing blueprint and selling strategy that delivers value to your customer.
> - Make decisions that focus on the important issues, the priorities, that influence change and transform the company.

Establish Leadership. There are no unrealistic goals, only unrealistic time frames. It is requisite that a leader envision the ultimate direction and goal, guide the efforts to overcome obstacles, to surpass milestones and motivate all stakeholders to achieve results. The task is larger than just managing the employees. It demands becoming involved and being excited enough to win. When you try to move a company forward without leadership it is tantamount to disaster and you are asking for trouble.

The qualities of a leader in a troubled situation are much different than in a healthy company; time compression and intensified external forces cause a different environment in which to operate. A good corporate renewal professional can make the difference . . . he or she brings confidence, experience under trying conditions and enthusiasm that can be infectious to stimulate the transformation. The good turnaround leader will accept, manage and overcome the risk — and there is risk in every turnaround. Believe in the people, expect and plan for the best, but prepare and provide for the worst.

It is imperative for the leader to understand this environment, for how else can he lead to success? Imagine how important it is for the workforce. Does the leader do the work or produce the widgets? No, his or her work is to provide direction. The true prognosis is measured when the workforce, all levels in tandem, are pulling toward the same goals . . . to get well and make the company grow. When this occurs, the cultural setup will be self-propelling and generate renewed momentum.

Put A Plan In Place. Devise a realistic plan and detail the underlying assumptions that were used. The plan needs to address the who, what, where, when and how of increasing sales and cutting costs. It should be a focused, no-nonsense plan that plays to your known strengths. More importantly, it must address the contingencies for the inevitable. . . some of your assumptions may prove wrong, the market shifted or some other unanticipated events put a damper on your plans. What happens then, in these conditions of change, is what will make or break the company. Don't become caught up in the minutia, break the plan into manageable tasks, provide guidance at the right level and implement.

This plan should address the issue of debt service in light of available cash, both today and in the future. If a debt restructuring is involved, when can the creditors and equity holders expect to obtain a return on their old and tired investment? If the wait is too long or the expectation of return is fraught with risk, they won't go along. Then again, if the alternative is liquidation they can only expect a few cents on the dollar . . . they will have virtually nothing more to lose and the level of cooperation may increase dramatically.

(Continued on next page)

Will Sees Major Challenges for Clinton

Contrary to popular belief, the election of Bill Clinton was not the most important result to come out of the ballot. In fact, if you ask George will, the presidential choice ranked 15th in the overall scheme of things. "More important were the 14 states where term limitations were approved," said Will. Congressional term limitations would signal an end to the "parasite class that make their money bending public power for private benefit."

Will, an author, columnist, and frequent guest on television's "This Week with David Brinkley," spoke at the 5th Annual TMA Conference.

Will, a staunch conservative, said he could offer no insight on the next four years under Clinton, "I haven't a clue as to what to expect" — but he did say that he was not optimistic. "Republicans have become victims of their successes." Since the problems of both the Cold War and the stemming of inflation no longer troubled the voters, they were more likely to vote for the Democratic option, Will said.

But Will admitted there will be plenty of problems for the new administration and new congress to face in the coming years — education is in desperate need of improvement. "Strictly speaking, America is in danger of losing its mind, " he said, adding that any improvement in the education system would have to start in the home.

He emphasized that more government involvement in education should not be sought. The government in Washington cannot do the one thing it's supposed to do — balance the budget.

Will suggested that the deficit is a direct result of the "permanent, careerist, legislative, dynastic Congress" that votes to fund home-district projects to remain popular. Will said he wasn't certain how Clinton will address the problems at hand.

Asked if he was pleased to see what appears to be an end to "gridlock" now that the Administration and Congress are both controlled by Democrats, Will answered no, emphatically.

"I love gridlock. The founding fathers planned gridlock . . . What the country has today (the same party in power of both Congress and the presidency) is what for 40 years we have said we didn't want," he said. All cynicism aside, Will concluded by affirming his belief in the American system.

"I have no doubt that freedom works. The American people are aroused and impatient, and I think that's good. I believe in the 'gate test' when talking about countries—open the country's gate and see which way the people go, in or out."

— NCR, January 1993

A Fresh Business Perspective — Musings *(Continued)*

Communicate With ALL Stakeholders. Whether an investor, creditor, customer, employee or owner, they all have a stake in the outcome and should be involved in the process. To exclude any interested party or slight the flow of information is a mistake that may be difficult, if not impossible to overcome. When a flow of real information is in place the parties become more involved, understanding of the situation and often more amenable to cooperate. Although, not an assurance of cooperation, count on major resistance from parties when information is withheld. It is human nature to be skeptical of what we don't know.

In communication the most important element is to establish trust with those that are involved. Never, ever, overcommit or fail to deliver what has been committed. Be realistic and be honest, if trust and cooperation are to be successfully developed. When you build trust, tolerance and flexibility will follow.

Rarely will all parties be happy with the way that things have turned out — quite the contrary. All stakeholders may have to reevaluate their expectations if the company is to reorganize and provide an opportunity for recovery. For certain, all stakeholders, by obligation, are part of the process. We naturally resist the possible fate of losing some, perhaps all, of an investment. It is never easy to accept loss, but not to be involved in the decision is catastrophe.

Execute A Marketing Blueprint And Selling Strategy That Delivers Value To Your Customer. Why else will the customer buy whatever it is that you are selling, unless he perceives worth? *Value* is established in the eyes of the buyer . . . which is often different than the way that you view things. The common mistake made by most managers is to think they know what is best for their customers — what a fallacy, not to mention the egotism involved. In reality, the customer and what motivates him is often unquestioned, unknown and ignored . . . and the disgrace is that this condition has been allowed to continue for too long.

Establishing the customer's "need based benefits" is key to consummating the sale. *Value* is measured at several levels . . . what perks initial interest . . . what motivates the sale in the first place . . . and what makes the buyer come back to order again? If you truly deliver value to your customer, be assured that he is willing to pay a reasonable price to realize it.

To generate sales or revenues you need orders. Obtaining orders efficiently is first a function of how well you position the company and its products and services relative to your competition; next it's tied to your ability to distribute what you are selling; but most immediately it is a revitalization of the selling force to create orders by closing on the known opportunities at hand. Business rarely occurs just because you show up. Execution is 1% inspiration and 99% perspiration. It is essential for the sales force to focus on the right issues to close new business . . . locate and cultivate a relationship with the decision maker, enhance the perceived value in the mind's eye of that decision maker, determine that budget is available to purchase and most importantly, close the transaction and take the order.

Don't confuse bringing home the order with doing so at any cost. Orders must contribute to gross margin . . . often at an improved margin ratio if the business is to regain health. Overcome the tendency to sell at any price just to generate cash . . . to do so will diminish the perceived value and send the wrong message. The customer will purchase when perceived value is greater than or equal to the price to obtain the product or service. It is unwise to expend time and effort greater than your gross margin to close a new order. Sell what you can provide today to those you know.

Often forgotten in providing value are two important supporting elements, manufacturing's ability to deliver on time and customer service. You must ship the product for revenue to be recognized. In some cases manufacturing know-how can provide a competitive advantage and create a barrier to other competitors. Reliable products improve customer satisfaction and reduce your overall operating costs. Cost reductions make you more competitive and increase profits . . . they also reduce the drain on cash.

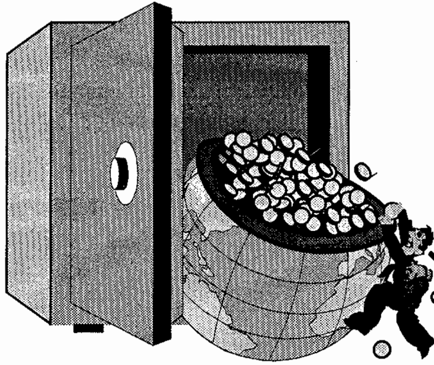
Your company image and future are on the line — and customer service is a key opportunity to differentiate both. Happy customers pay their bills on time and receivables cease to be a problem when the customer discerns value and ongoing support. Service is critical to filling your customer's need. Every employee is a salesperson and their attitude counts . . . from the way they answer the telephone . . . or respond to requests . . . to the timeliness and completeness of problem resolution.

Make Decisions That Focus On The Important Issues, The Priorities, That Influence Change And Transform The Company. Remember, Cash is king . . . capable people are the scarce, adaptable resource required to execute . . . leaders establish priorities, communicate them to those who can affect change and stand behind a consistent message . . . build confidence and communicate with all stakeholders . . . fill a basic customer need and deliver a product, not the technology, that satisfies that perceived need . . . emphasize and sell value and benefits received rather than price . . . respect and service your customers. . . and concentrate on relentless execution.

— NCR, September 1993

Where in the World Are You Headed?

How to Win Business by Transitioning into New Markets



By John M. Collard

The conversion to a peace-time economy is forcing many companies into a real battle for increased sales. But unlike war games, new markets don't always produce victorious spoils.

Businesses that head blindly into uncharted markets are asking for peril. One-time missile manufacturers and former F-14 fabricators are looking for new markets and forcing sales-starved CEOs at small to medium-sized manufacturers into new territories without the proficiency to generate revenue once they get there.

The end of the cold war is shaking regional economies from the roots. During the '80s, defense contractors flourished in spite of sound business principals. The government mandate to cut defense spending has forced many contractors to adjust, abruptly. Most don't know how. Their efforts often fail.

Considering that the Pentagon spends 60 cents of every dollar in just three regions: the Mid-Atlantic, the Northeast and the West, and that by 1997, the defense conversion will have touched some 2.6 million people and companies in those areas, CEOs should be constantly evaluating their current market positions.

Even if your company hasn't been affected by the defense conversion yet, it will be. Your first reaction to the increased competition may be to look for new markets. But new markets bring new rules and new ways of doing business — look before you leap, and if you don't know the way, find someone who can help take you there.

To move into a new market segment requires a different way of doing business — a fundamental change in approach. While it's possible to make the shift from government contractor to commercial supplier, and from commercial supplier to international manufacturer, you will need to understand that customers behave differently in each marketplace. Their motivation and timing are altogether different from what you may be used to. You won't be able to do business in targeted new markets unless you understand this first. Trying to generate sales in new markets with your old strategies just won't work.

For example, in federal competitive procurements the trend is toward commodity-based solutions. Where personnel is one part of that solution, the trend is toward lower fee environments. If your company's marketing efforts are geared toward building relationships first, your competition will be out the door with the contract while you're still warming up to the procurement officer. In this market, you'll have to think about pricing to win, then working aggressively afterwards to cut costs or negotiate adjustments.

On the other hand, commercial buyers look for cost-effective (typically fixed-price) solutions that operate within and compliment existing investments. In the international market, environments are productized, but the bottom line is that it's who you know — or don't know — that counts.

Typically, you'll find yourself steering your company into one of three major market categories. To enter new markets, you will have to posture your company differently in each environment to win business. Here's a look at each major market segment:

Government Contracting

Two markets are open for opportunity within the government contracting sector. There are government set-asides, which primarily are targeted for small and disadvantaged businesses. Here the government is the buyer purchasing from a qualified seller. Set-aside programs are limited to those who can participate and the key here is to get there first.

If you are targeting the government set-aside market you will find a constantly churning market of entering and exiting players, all of which are vying for contracts in the $10,000 to $10 million range. What you do is more important in this market than how you do it. This market has become somewhat easier to enter since the government has mandated an up to 5 percent minority set-aside program for federal procurements.

Larger federal procurement contracts are obtained through a sometimes quite lengthy and very competitive bid process. Again, the government is the buyer through this extremely structured process, but the competition is scattered among the major aerospace and weapons companies, major suppliers, established systems integrators and small businesses.

Reputation is important when it comes to securing federal contracts, and teaming is essential to showcasing unique skills and relationships to accomplish the job. Competitive bids require a significant corporate commitment just to win the contract. Additionally, there is a second tier of competition brought on by subcontractors who are bundling services to win contracts and become part of larger teams.

The low bidder is always the winner in the competitive government contracts market. But the low bidder may not always have the lowest price. Today, contracts are going to the "lowest evaluated bidder," or the bidder who brings the most value for the price to the table. Lowest-evaluated bidders have been beating up the lowest-priced bidders for some time now and are proving to be stiffer competitors. Plan for long lead times, mountains of paperwork, and rock-bottom pricing in the somewhat flat new acquisitions market. Businesses go fishing for deals anywhere from $5 million to $100-plus million to $1 billion in this market segment.

Commercial Market

Most businesses will look to the wide-ranging and economically unrestrained commercial marketplace for new opportunities. But pitfalls await anxious CEOs here, as well. Sellers approach buyers at will and are subject to buyer's whims. Your industry knowledge is paramount and your products and services must be easily defined and understood.

While profit margins typically are higher and relationships ensure future stability for service-oriented companies, buyers are fickle. You may be providing exactly what the buyer needs, but that buyer may suddenly decide he or she doesn't like your tie. And by the way, one of your competitors may have a similar, yet inferior product, but it's starting to look better than yours because your competitor has had the buyer out on the golf course three out of the past four weekends talking about everything but product.

Relationships mean everything in this market and they are maintenance-intensive. The commercial market is Darwinian — with project and results-oriented customers, performance under pressure is the key to survival here.

International Market

As more businesses wander outside the borders of their native countries, the international market will become increasingly more competitive. Yet you won't find it any easier to navigate until others make inroads. For U.S. companies, the international market remains one of the toughest to enter. For the willing CEO, there's little, if any, access to good information, no mentors to follow and no established communication channels.

(Continued on next page)

Strategies For Winning Business in New Markets

STRATEGY	GOVERNMENT	COMMERCIAL	GLOBAL
Contact Environment	Life-cycle award; Structured by FAR	Not structured; UCC governs	Rules of country; $ Exchange rates
Market Environment	Limited; Highest-value wins	Caveat Emptor; Business abounds	Wide Open; Who You Know/Pay
Distribution/ Differentiators	Procurement process; Design to spec	Salespeople; Alliances	Incestuous; local presence
To Win	Fair value for $	Demonstrate Benefit	Boost local economy
Technology Importance	Very important; Military-oriented	Solution focus; Commodity-driven	Paramount; Transferable

In the international market, in fact, relationships can be downright incestuous. While it's possible to successfully enter international markets, don't underestimate the power of local presence. Countries like to keep the currency local and limit the export of profits. They favor companies that invest in their economy. Both Ford and Honda have proven this point with their widely scattered worldwide plants. But not all markets are open.

While the U.S. welcomes foreign competition, some countries limit entry. Limiting tactics often range from burdensome import duties and competition-limiting treaties to competing against local government-subsidized bids. And don't be surprised to find yourself paying "entry" fees all the way through a power structure that includes distributors who may well be the king's nephews.

Going after business in the global market is a lot like fishing in the ocean — there's plenty of opportunity for that big catch, but you're far from guaranteed a fish. Which is why fishing is called fishing — not catching. You may have plenty of opportunities for business internationally, but if you don't know how to take advantage of them you won't land any new business.

Technology transfers and contacts abroad will help you generate international sales, as will a willingness to learn new customs and adapt to new business environments. U.S. businesses are relative newcomers to the international markets. Japan and countries in Europe have been doing business internationally for years. Additionally, there's increasing competition from third-world countries and Eastern-bloc nations with low labor costs.

So what does it take to win business in new markets? In set-aside contracting, the work must be completed by a small, disadvantaged business. While the government procurement cycle is structured to be fair to all, and to level the playing field, the commercial market is driven by solutions and products and services that fill niche needs within a specific time frame. Foreign buyers are commercial in nature, yet they favor their own suppliers unless what they need can only be purchased abroad. But they may only be outside their own borders for a short time seeking technology transfers as many technologies are replicatable.

Companies should approach new markets with realism in mind. Venturing into new markets exposes unknown territories and pitfalls to unseasoned leaders.

Companies that don't adapt will be forced to cut back: Connecticut's Pratt & Whitney division of United Technologies used to sell some 700 military jet engines a year. This year, orders have dropped to around 50 engines.

Any significant drop in sales usually leads to a shake-out in employment. For example, in Maryland, Westinghouse Corp.'s electronics division has reduced its workforce by 40 percent in the past five years. In the height of the defense build-up, Westinghouse employed more than 17,000 people in the region. Today, it employs less than 10,000 there. Companies that don't adapt during the defense conversion will continue to be cut back.

Westinghouse, like Pratt & Whitney, is seeking to diversify its commercial base, but most businesses don't have a back-up plan just in case their major customer walks away. Instead, Plan B often becomes a boot strap effort to reach out to the "hot market of the month," typically a segment that has been tapped out even as it soars in popularity.

Do your homework before you head for the boardroom — read everything you can get your hands on about your target market. Narrow your focus and take a rifle shot at your new-found customer — chances are if you've learned the lifestyle and adapted to the business-style of your target market — you'll hit your mark.

Always aim well; you seldom get a second chance.

Determine if your company has products and skills that are transferable to new markets. Where can you sell a long-range bomber or a guided missile system? To a foreign power? Since foreign military sales are governed by the Pentagon, you probably don't have a viable market.

But the technology that was used to develop your product may have specific applicability in other arenas. You may have to change the look and feel of what you're offering depending upon what the new customer needs. San Diego's XXsys Technologies, Inc, is taking the ultra-strong materials it used to pump into B-2 bombers and is now putting them into bridges and roadways.

Know your strengths and exploit your competition's weaknesses — do your products and services beat the competition in terms of technology, or design, or cost?

You'll also be limited by the size of your own company's resources — tackle only one or two market niches at a time — don't go choking on the big bite.

And don't make self-serving assumptions — remember to protect the market share you've already earned while you reach out for new business. The markets you neglect while reaching toward new sales become prime targets for your competition.

Above all, be willing to throw all assumptions out the window — new markets bring new personalities, customs and business traditions to the table. Watch for these subtle nuances and welcome the opporutnity to demonstrate your willingess to adapt.

— NCR, November 1993

Where Do You Go When the Bank Says "No?"

By Barbara Anderson

Small- and medium-sized businesses requesting loans hear "no" all too often from their local banker, even after many years of dealing with them. Very often the best solution is a change of lender. We all know the difficulty in getting a "workout" in one bank refinanced by a another bank, so what are some of the alternatives?

Asset-Based Lending

First, there are asset-based lenders. A typical borrower in an asset-based lending situation is a leveraged manufacturer or distributer that has a significant investment in short-term assets, such as receivables and inventory. This borrower has a need for "permanent working capital" and cannot meet the clean-up requirements of most banks. The basic premise of asset-based lending is to make sure that the collateral pledged for the loan (typically accounts receivable and inventory), at liquidation value, would be sufficient to pay off the loan even if the borrower did not make it. Therefore, asset-based lenders advance against a percentage of eligible assets. Eligible accounts receivable are typically defined as gross receivables minus receivables more than 60 to 90 days past due, foreign receivables, receivables due from affiliates, and reserves for credits, returns, and allowances. Advance rates range from 75 to 85 percent against eligible accounts receivable. Eligible inventory usually includes finished goods and raw materials owned by the borrower. Advance rates vary from 20 to 60 percent of eligible inventory and are based on the borrower's gross profit margin, historic inventory turnover and the lender's assessment of the inventory's marketability, perishability and risk of becoming obsolete.

Because asset-based lenders are called into situations where banks will not lend, the increased risk as well as heavier workload in closely monitoring the borrower and the collateral requires higher pricing than typical bank financing. The borrower can expect to pay Prime+1 percent to Prime+6 percent per annum plus monthly maintenance fees and an annual commitment fee.

A major difference between asset-based lending and bank financing is the high level of collateral monitoring that takes place in an asset-based lending situation. The borrower will be required to provide frequent reports on the collateral constituting the asset-based lender's collateral. In addition, asset-based lenders frequently audit their borrowers to insure that the reporting made on receivables and inventory is accurate. Another element critical to an asset-based lender's evaluation of a borrower is the quality and commitment of its management team. Past operating performance, internal controls, management depth, industry experience, equity investment and ownership percentages are closely evaluated. Very often "key-man" life insurance is required.

The goal of most borrowers in an asset-based lending relationship is to stay alive long enough for the business to improve to a point where the borrower can once again attract bank financing. All of the major U.S. banks have asset-based lending departments or subsidiaries. In addition, there are many independent asset-based lending companies around the country. The Commercial Finance Association in New York City provides listings of its member organizations.

Factoring

Those borrowers that are rejected by asset-based lenders can access factoring as an alternative. Factoring is often perceived as a high-cost source of financing for companies in serious trouble. But a company that is willing to take a fresh look at factoring may find several good reasons to disregard this age-old stereotype. The major difference between factoring and asset-based lending is that a factor purchases the accounts receivable of its client and assumes the related credit and collection risk. Under an asset-based lending relationship, the lender has a security interest in the borrower's receivables but the borrower retains the credit and collection risk. Factoring has been most closely associated with the textile and apparel business but in the last five years has rapidly expanded to many different industries, including trucking, furniture, toys, service businesses, government contractors, and medical institutions.

Outsourcing collections can result in labor and space savings by eliminating existing collection departments. In addition, customers of companies that factor may have more incentive to pay the factor quicker so as not to tarnish their credit reputation. This results in a reduced borrowing need for the company that factors its receivables thereby reducing its overall factoring costs.

Factors check their client's customer's credit. Factors will also do credit checks on potential customers and while they don't prohibit a client from selling to a particular customer, they may set a credit limit reflecting the risk associated with doing business with that customer.

Typically, factors charge a commission on the gross receivable purchased to cover the cost of collections and bad debts. Factoring expense can range from as little as 1.5 percent of sales up through 10 percent of sales.

To a growing company, the quick access to a constant source of cash can be invaluable. To a small company where even one customer payment default can be devastating, the credit evaluation provided by a factor can make the difference between surviving and going out of business. For the undercapitalized company that cannot attract an asset-based lending relationship, factoring can be an alternative to shutting down or selling equity. And for the company that needs to concentrate on new product development and sales, the collection services provided by factors could be very attractive.

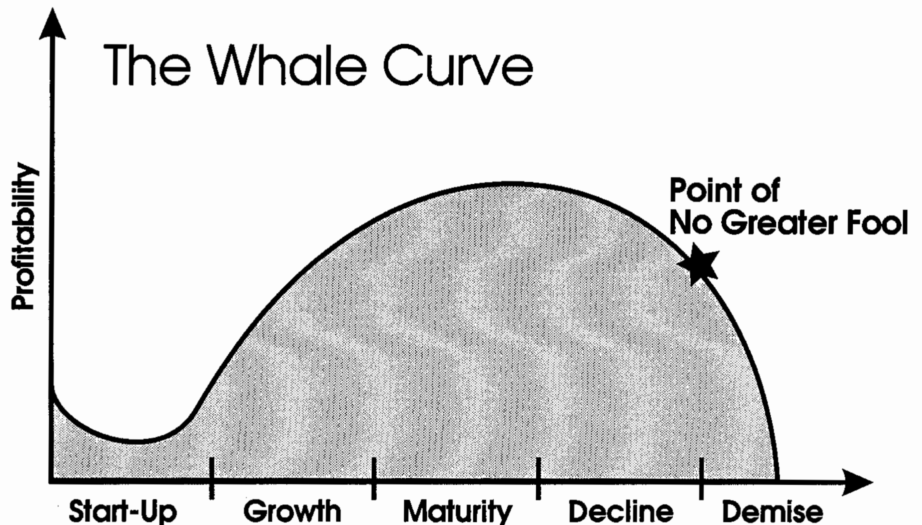
The equity market is a third alternative. While the Initial Public Offering (IPO) market might be available now, keep in mind the market is fragile and could close at any time. Investment bankers specializing in small companies can assess the potential for an IPO. For troubled companies, however, this solution is only viable once a turnaround is evidenced. Another alternative is selling equity in the business to a deep-pocketed, strategic investor. Finding this kind of match can be time consuming and frustrating. Lastly, mezzanine capital is debt that is junior to that of asset-based lenders but senior to common equity. This form of debt usually carries a high interest rate and debt conversion features. Sources of this type of capital include venture capital firms, insurance companies, pension funds and small business investment companies, to name a few. *— NCR, November 1993*

In Lending, There's No Fool Like the "Greater Fool"

By Keith E. Lawder

The Greater Fool Theory highlights the bank's need to preserve liquidity through refinancability. The maxim goes something like this: You should never make a loan unless you are convinced that there will always be another willing lender (a greater fool) around at precisely that time when you wish to exit the credit.

Lending involves painful periodic reminders about the need for liquidity in our assets. When we fail to provide sufficient margins of safety on our loans, we find the cost of a workout consumes more than the sum of all historical profits on an account. We readily recognize that the least expensive way out of a workout is to refinance with another lender. However, all too frequently, we neglect to leave enough margin for safety in our deals. The result? We become the lender of last resort, intentionally or not.



Sound underwriting begets careful evaluation of safety margins. Prudent structures and covenants preserve the inherent liquidity in a well-underwritten deal. Yet, the battlefield is littered with the bodies of lenders who ignored the greater fool theory and then went on to become one.

Point of "No Greater Fool"

Borrowers' performances fluctuate, and when depicted graphically, these fluctuations might look like the "whale curve". Borrowers seek bank funds on the sloped portions of the curve to finance growth or losses. The prudent underwriter will recognize where the borrower is on the curve and structure the credit accordingly.

At some point on the whale curve, however, no lender will grant additional credit to the borrower, and this is the point of no greater fool. We must find the point of no greater fool in order to structure deals soundly.

Estimating this critical point is more of an art than a science. It must be predicated on a solid understanding of the company and its asset values, as well as knowledge of alternative lenders and their credit appetites. Greater fools are understandably reluctant to advertise their decision criteria!

> ***"...When no lender will grant additional credit to the borrower, this is the Point of No Greater Fool..."***

Using the Theory

With knowledge of the point of no greater fool in hand, we can adjust terms, maturity and covenants to provide adequate time (before reaching the point of no greater fool) for corrective action. The lender can offer structure and terms which preserve the asset values and the refinancability of the borrower. Collateral features tend to address asset value preservation. Covenants speak to refinancability. The lender's objective is to establish financial covenants which, if violated, would create an event of default sufficiently in advance of the point of no greater fool.

One recommended strategy is the use of tiered financial covenants. Rather than setting a static tangible-net-worth-to-debt covenant, for example, we might negotiate a covenant with requirements that increase periodically over the life of the loan, in accordance with the borrower's projections for an improved balance sheet. This strategy takes into account the generally steeper slope on the decline side of the whale curve.

We also should consider the return expected for the risk taken. The proximity to the point of no greater fool and the size of the safety margin offered by the loan's structure should play a role in pricing. The ultimate structuring tool in any credit is the amount we will lend.

Should an event of default occur, the lender really has but three options. The safety margins of assets and collateral as well as proximity to the point of no greater fool determine the best course of action. Option one is to restructure—a prudent loan can usually be saved by a change in terms of maturity or collateral. If the lender has lost confidence the borrower's ability, refinancing may be pursued—but only if the company's position on the whale curve (their proximity to the point of no greater fool) is known. Some institutions will reduce the collateral cap to reduce risk; or "wind down" the loan balance as funds come in. The final option is to accelerate on the debt and foreclose on any collateral. This avenue tests all parties. It also challenges the underwriting assumptions.

Conclusion

Underwriting, structure, terms, pricing and amount are all key components of quantifying and managing the risks of a credit. Each requires skill and judgment. Understanding the whale curve and applying the principals of the greater fool theory can help keep these judgments sound.

— NCR, September 1993

Asset-Based Financing
Understanding Credit Criteria

By Michael Lerner

Troubled companies are continuing to find that credit is tightening. In fact, even borrowers with good credit ratings are being told they are not "bankable," a result of recent federal regulations tightening loan restrictions. This makes it even more difficult for companies in financial distress.

Asset-based loans may be the solution to these financing needs. Unlike traditional loans which are usually based on cash flow, asset-based lending allows companies to borrow against their fixed assets (accounts receivable, inventory and machinery and equipment) providing badly needed capital for refinancing, leveraged buyouts, recapitalizations, acquisitions, Chapter 11 reorganization and debt restructuring.

Asset-based lenders usually use two criteria to evaluate potential borrowers; collateral and a realistic turnaround plan.

Financing Against Collateral

Lenders emphasize the quality of a company's collateral when evaluating a potential borrower.

Revolving lines of credit are based on accounts receivable and inventory. Companies may be advanced up to 85 percent of their eligible accounts receivable. A few types of receivables are not considered eligible such as progress billing, consumer and credit card receivables, over ninety day accounts and generally, receivables subject to offset.

Companies may be advanced up to 60 percent of eligible inventory, which includes raw materials and finished goods. Work in progress or consignment inventory is normally not eligible. Revolving lines of credit require no amortization; no annual "clean up".

Term loans are based on machinery and equipment. A company may be advanced up to 80 percent of the knock down value of machinery and equipment and these loans can be amortized for up to seven years.

Term loans are not provided on a stand alone basis. Companies typically receive a revolving line of credit and then, if they need additional funds, apply for a term loan as well.

Lending on real estate collateral is not popular today.

There are many factors that determine the percentage of eligible collateral that will be advanced. Each transaction is unique and customized to meet specific client needs.

The Turnaround Plan

Banks look at a company's history, particularly cash flow, to determine availability of funds. Asset-based lenders, however, look at today's situation.

In addition to collateral, asset-based lenders will look to see if a potential borrower has a realistic turnaround plan and will consider that in making a loan. Since the management responsible for turning a company around is often the same management responsible for the company's problems in the first place, independent consultants are often called in to help out.

Lenders sometimes go beyond collateral in evaluating a company, examining management, growth opportunities, products, and market potential.

CONSIDERING ASSETS: AN EXAMPLE

The XYZ company has a net worth of $1,000; yet, it could probably qualify for a $100,000 asset based loan.

XYZ Company Balance Sheet

Accounts Receivable	100
Inventory	50
Total Assets	150
Accounts Payable	149
Stockholders Equity	1
Total Liabilities and Stocholders Equity	150

The potential loan can be determined by multiplying the maximum advance rates.

Assets	Amount	Advance Rate	Maximum Advance
A/R	$100,000	85%	$85,000
Inventory	50,000	60%	30,000

Since all these assets may be considered "eligible," $100,000 is a reasonable estimate of the advance. This results in the lender's debt to net worth of 100 to one. A bank, on the other hand, will allow a 4 to 1 debt to equity ration and lend only $4,000.

	Loan		Debt to Net Worth
Bank	4	←	4:1
ABL	100	→	100:1

If this company's business cycle is seasonal, or if it's expanding or losing money, bank lending would probably be insufficient. An asset based lender relying more on collateral is able to offer significantly more funds.

Who Benefits from this Financing?

Your client may be a candidate for an asset-based loan. Here are some common signposts:

- Working capital tied up in accounts receivable and inventory
- Rapid sales growth taxing existing resources
- Seasonal inventory expansion straining cash position
- Insufficient cash flow to meet debt service requirements
- Missing opportunities to take advantage of trade discounts

Financing Parameters

Funding from $2 to $10 million is available to qualified clients. Interest rates range from 3 to 5 percent over prime depending on the situation. Terms range from two to three years for revolving lines of credit and five to seven years on fixed asset loans.

CIT Group/Credit Financing

CIT has provided asset-based financing to many distressed companies when no one else would or could. In fact, CIT likes to say that difficult transactions are a specialty.

CIT will often extend an advance to a company that exhibits growth potential even if it doesn't have working capital or to a company with a strong management team and a good financial plan.

Manufacturers, wholesalers, distributors and service industries are the most likely candidates. Retailers, hotels, condominiums, apartment and shopping complexes and construction companies, due to their reliance on real estate as collateral, are not able to receive CIT's financing. *—NCR, January 1993*

Mezzanine Financing . . . Is it Appropriate?

By Jeff Toole

In spite of general denials from professionals in government and the financing community, the fact remains that it is becoming increasingly difficult for middle market companies to obtain credit to finance their business activity. The availability of financing is further constrained for those companies experiencing some form of financial distress.

Is mezzanine financing an appropriate alternative for companies involved in a turnaround situation? The answer to this question is dependent upon the individual characteristics of each particular situation. To evaluate the potential to utilize this type of financing, one needs to be generally familiar with the terms and criteria of mezzanine lenders.

Mezzanine Lending Criteria

Mezzanine providers wear both a lender's and equity investor's hat. The total internal rate of return on a loan is derived from the current coupon (ranging from 12.0% to 14.0% paid on a current basis), the closing fee (2.0% to 3.0%), and capital gains derived from warrants received for a negotiated percentage of fully-diluted ownership of the company, to boost the total internal rate of return on the loan to 25.0%. The loans are long-term, with final maturity occurring seven or eight years after funding. Most will provide for a period of interest-only payments, but all are subordinated, in right of payment, to the lender of existing or allowable senior financing of the borrower.

If a questionnaire was sent to the mezzanine lenders in the market, asking them to describe the characteristics of a potential borrower, most would list some or all of the following:

- A high quality, experienced management team that has a significant personal investment in the borrower;
- A dominant market share or a protected niche market, or participation in markets with significant barriers to entry;
- A diversified product and geographic sales mix;
- A realistic exit scenario that provides potentially attractive returns on the lender's warrant position; and
- Projected cash flow that is realistic and that provides adequate interest and principal coverage under conservative economic conditions.

Many companies suffering financial distress can exhibit some or all of these characteristics, but they all don't qualify for loans.

Appropriate Situations

Let's look at an example. Company A designs, manufactures and markets high performance equipment for the computer industry. The management team is sound. Its products and customer base are of high quality, the products are sold nationwide and each has a significant share of its end market. Company A acquired another company intending to consolidate operations into its existing facility. Consolidation costs, new product introduction disruptions and expenses caused by the ongoing assimilation, and a temporary six month suspension of all product purchases by the company's largest customer have caused net losses and cash flow difficulties. The company's existing senior lender is forced to overadvance against available assets. Accounts payable are converted to notes and the balance of accounts payable are stretched past sixty days.

The difficulties have been solved, however the company needs additional financing to rationalize its capital structure, clean up its past due payables situation, and provide funds for expansion. This is a solid company with predictable future cash flows, thus mezzanine financing is indeed a viable alternative.

Mezzanine can also be used in other situations of financial distress. It can be utilized to finance the purchase of the money losing division of a larger company which would be profitable if costs could be rationalized by consolidating plants, leaving behind pension and post retirement obligations or economically burdensome union contracts.

Mezzanine is also available to recapitalize a company which is profitable on an operating basis but which is simply overleveraged. In a case such as this, negotiate and document a discount with the existing lenders prior to seeking replacement financing.

The common characteristic of these situations, where mezzanine financing is appropriate, and others not mentioned here, is that the changes and improvements necessary to return the borrower to financial health are tangible and calculable. The cash flow improvements will happen immediately upon the implementation of the solutions, thus giving the mezzanine lender the ability to evaluate the predictability of cash flow and the likelihood that interest will be paid.

Inappropriate Situations

Mezzanine financing is not appropriate for Company B. The company owns a chain of restaurants. The menu consists of items no longer in favor with consumers. The decor is outdated. Competition from newer concepts is intense. Customer traffic has consistently fallen and losses have mounted.

A new management team has been hired and has put together a very solid business plan to update both the menu and decor, with the belief that profitability can be restored, but additional funds are needed to accomplish the task. The business plan may work extraordinarily well, but the difficulty, for a lender, is that the resulting improvements, and thus cash flow, are based more on intangibles. They are difficult to "touch and feel." The risks inherent in the needed investment, and therefore the commensurate return, are better suited for an equity investor, who is not dependent on current interest payments to provide a large part of the resulting return.

Most mezzanine lenders have a real or perceived cost of funds, so current interest payments are critical.

In Summary

Evaluate the merits of each situation individually. If the borrower can make tangible changes which will result in immediate, predictable and measurable improvements in cash flow, many, but not all, mezzanine lenders will be willing to consider an investment. If, however, the necessary improvements are dependent upon intangibles and will take an extended period of time to directly affect the borrowers' cash flow, other sources of investment are better suited.

A final word of advice to potential borrowers. Know your lender. Mezzanine loans are long term, seven to eight years. Will the person you are dealing with today be there next month? How will they deal with the difficult situations which almost always arise? Will these people help your company maximize its potential? The answers to these questions, and others, need to be answered affirmatively.

— NCR, March 1993

The Subordinated Debt Paradoxes

By Wendell H. Adair

The Subordinated Debt Market, a creature of the eighties and nineties, contains two paradoxes which must be understood by successful turnaround practitioners.

To begin with, to say that one debt is subordinated to another debt is in and of itself meaningless. Existing case law establishes that this statement standing alone is so vague as to be unenforceable. Indeed, the subordination relationship is wholly contractual and therefore the underlying subordination agreement, together with the subordination provisions set forth in the applicable indenture or notes must be carefully reviewed to determine the relative rights and obligations of senior and subordinated debt.

The subordination agreement itself signals the existence of an agreement between creditors who would otherwise share equally in any distributions resulting from a bankruptcy. Because of the existence of the subordination language, the senior creditor has the benefit of a "double dip" or "double dividend" in a bankruptcy case. The key factor here is that bankruptcy courts will recognize and enforce subordination agreements among creditors.

The "double dip" or "double dividend" is best described as giving a senior lender the opportunity to take its share of any distribution in a bankruptcy plus (to the extent of any deficiency that it may have) up to the full share of any distribution to the subordinated lender. Table 1 demonstrates the double dip phenomenon.

Table 1

DOUBLE DIP SCENARIO

UBL	$100
USL	$100
UTC	$100

Available for Distribution$150

	Bankruptcy Plan	Double Dip
UBL	$50	$100
USL	$50	$ 0
UTC	$50	$ 50

For purposes of this illustration, it is assumed that the estate has been liquidated and $150.00 is available for distribution to three unsecured lenders each owed $100.00. The three creditors are an unsecured senior bank lender ("UBL"), an unsecured subordinated lender ("USL") and an unsecured trade creditor ("UTC"). Under the bankruptcy plan, each such creditor would be entitled to $50.00 or one-third of the available estate. Because of the subordination agreement, however, the double dip would permit the senior bank lender to receive both its distribution and that which would otherwise have been made to the subordinated lender. Thus, the senior bank lender would be entitled to a "double dip" and receive $100.00, while the subordinated lender would receive nothing.

Based on this background, we can now explore two key subordinated debt paradoxes. The first subordinated debt paradox is that under most circumstances, unsecured bank lenders would prefer that an investor invest in sub-debt rather than equity. Table 2 illustrates this paradox.

For purposes of this illustration, it is assumed that the previous unsecured subordinated lender had made an equity investment of $100 rather than a $100 subordinated loan. Under such circumstances, the unsecured creditor class in a bankruptcy would consist solely of the unsecured bank lender and the unsecured trade creditor. Thus, the $150.00 estate would be split one-half or $75.00 each to the unsecured bank lender and the unsecured trade creditor.

Table 2

EQUITY PARADOX

UBL	$ 100
UTC	$ 100
Equity	$ 100

Available for Distribution $150

	Bankruptcy Plan	No Double Dip
UBL	$ 75	N/A
UTC	$ 75	—
Equity	$ 0	—

This paradox demonstrates that from the perspective of the senior bank lender the introduction of subordinated debt permits the senior bank lender to transfer value in a bankruptcy estate from unsecured trade creditors to itself through the double dip mechanism.

The second subordinated debt paradox is the "security conspiracy". Simply put, junior subordinated lenders should want to "conspire" with bank lenders to make sure they are secured.

Table 3

SECURITY PARADOX

SBL	$ 100
USL	$ 100
UTC	$ 100

Available for Distribution $150
($100 of which is proceeds of Secured Bank Lender collateral)

	Bankruptcy Plan	Double Dip
SBL	$ 100	N/A
USL	$ 25	—
UTC	$ 25	—

Table 3 demonstrates that the unsecured subordinated lender can profit from having the senior bank lender collateralized.

The "security paradox" is best illustrated by comparing Table 1 with Table 3. Because of the double dip under Table 1, the senior bank lender ended up with $100.00, the subordinated lender with nothing and the unsecured trade creditor with $50.00. Table 3 assumes that the estate consists of $150.00 available for distribution, of which $100 represents the proceeds of the secured bank's collateral. Under these circumstances, the secured bank lender ("SBL") would receive $100 and the unsecured creditor class would consist solely of the unsecured subordinated lender and the unsecured trade creditor. For this class, the proceeds available for distribution would be limited to $50 which would be shared one-half each or $25 with the subordinated lender and the trade creditor. Thus, as a result of the collateralization of the bank debt, the subordinated lender was able to reduce the payment to the trade creditor from $50 under the scenario described in Table 1 to $25 and increase his retained distribution from zero to $25.

An understanding of these two paradoxes is important when negotiating new financing transactions or restructuring of existing balance sheets.

— NCR, July 1993

FINANCE

IMPLEMENTING SFAS 106: *Employers' Accounting for Postretirement Benefits Other Than Pensions*

By Kamal M. Advani, Murray S. Akresh & Barbara S. Bald

Statement of Financial Accounting Standards (SFAS) 106, generally requires employers to switch to accrual accounting for their retiree health and other postretirement benefit plans by the first quarter of fiscal 1993. The impact on financial statements can be significant.

Field test studies conducted on behalf of the Financial Executives Institute and the Institute of Management Accountants confirmed this. They showed an estimated first year expense, based on amortizing the transition obligation, ranged from 2 to 6 times the current pay-as-you-go expense for mature employers (up to six active employees for every retiree). Immature employers (more than six active employees for every retiree) experienced higher multiples.

The good news for troubled companies is, the accounting standard, by itself, does not affect cash flow. However, implementation can significantly increase liabilities, expense and stockholders' equity, resulting in higher debt/equity ratios.

Financial & Reporting Considerations

To plan for the adoption of SFAS 106, employers need to assess available strategies and choices. The primary financial reporting issue that must be addressed, is whether it is advantageous to immediately recognize the transition obligation, or amortize it over 20 years?

Immediately recognizing the transition obligation may be viewed as advantageous, because it improves earnings for the next 20 years by eliminating amortization of the transition obligation. The charge to earnings will be 'below the line,' as a cumulative change in accounting principle. Furthermore, financial analysts seem to be encouraging immediate recognition and some employers are concerned that analysts will deduct (for analysis purposes) the disclosed but unrecognized portion of the transition obligation. For employers whose obligation is very large, immediate recognition would reduce a significant portion of stockholders' equity and may place them in violation of loan covenants. For these employers, prospective transition will likely be chosen.

To make appropriate decisions, it is important to project retiree health and other postretirement benefit obligations and expense over the next 5 to 10 years. Only when the future impact of SFAS 106 is understood will employers be in a position to plan their strategies.

What Affects Obligations and Expense?

The magnitude of obligations and expense is impacted by the design of the plan, demographic characteristics of the covered population, and the actuarial assumptions used for measurement.

The demographic makeup of plan participants should be considered in making plan design decisions. The number of eligible employees, their age and length of service, the number and age of existing retirees and their covered dependents, all influence the extent of the impact of SFAS 106. Although it is important to understand the dimension of demographics, generally, you have little control over this element.

The determination of obligations and expense is based on an estimate of the present value of future benefits to be paid. To estimate this payment stream, actuarial assumptions pertaining to who is to receive benefits; when are benefits to be paid and for how long; and the amount of benefits including consideration for health care costs, are used.

While SFAS 106 requires that each actuarial assumption represent the employer's "best estimate" of future events, there is some flexibility in the selection of these assumptions. Employers need to recognize the implications of the actuarial assumptions because they can have a significant impact on the magnitude of the obligation and expense.

In determining the health care cost trend, you should consider an estimate of health care inflation, changes in health care utilization, technological advances, and changes in the health status of participants.

Most health care cost trend rates reflect an employer's current cost experience in earlier years (e.g. 14%) with the rate decreasing to an ultimate rate (e.g. 6%), under the rationale that if health care in the U.S. continued to increase at its current rate, expenditures would reach an unreasonable proportion of the gross national product. Due to the uncertainty surrounding the cost of future health care, there is flexibility in the selection of this assumption. However, if a low health care cost trend assumption is used in early years and actual health care experience is greater than assumed, actuarial losses will be generated which may increase future year expense.

To select the discount rate, SFAS 106 requires employers to look to rates of return on high-quality, fixed-income investments currently available, whose cash flows match the timing and amount of expected benefit payments. While it is expected that most employers will use retiree health discount rates equal to the rates used for pensions under SFAS 87, the study showed that 1/2 of employers that adopted SFAS 106 early, used different rates.

Why would rates differ? Under SFAS 87, employers can look to rates used to settle pension obligations as well as those required under SFAS 106. Settlement rates are not applicable to retiree health obligations, and the stream of benefit payments will differ for pensions and retiree health benefits.

Plan Design Changes to Mitigate Impact

There are options available. Because changes will have financial and human resource implications, the form and timing must be carefully considered. Before implementing any changes, identify the goals, the alternatives, the relationship of changes under SFAS 106, then 'run the numbers' to determine if they will yield the desired effect.

Several changes are currently being considered by employers:

- **Cost-Sharing** - increase the portion borne by retirees through contributions, deductibles and other techniques.
- **Indexing** - increase contributions and other amounts to keep pace with economic indicators.
- **Vary Benefits** - provide lower benefits to employees with fewer years of service or that retire early.
- **Strict Eligibility** - eliminate coverage for some employee groups by requiring more service for coverage or other benefits.
- **Cap dollar-denominated benefits** - set a maximum employer commitment to pay future benefits, any costs in excess are borne by the retiree group.

The accounting rules require employers to anticipate changes in the cost-sharing provisions of a plan. The capped plan may require anticipating increases in the cap, once a past practice of increases has been established. At some point, this could result in an increase in the obligation. The SFAS 106 rules are judgmental. Evaluate both near and long term effects of possible changes to a retiree health program.

Clearly, there are strategies that can mitigate the adverse impact on the financial statements. Management should follow a well thought out plan and fully examine the accounting, actuarial and plan design options. There is no one plan that is right for all.

— NCR, January 1993

Financial Aspects of Fraudulent Conveyance Analysis

By Kamal M. Advani

Fraudulent conveyance actions brought against participants of failed LBO transactions have increased the burden on all parties in the merger and acquisition arena. Although few plaintiffs have prevailed in these suits, it is not uncommon for unsecured creditors in a bankruptcy, involving a failed LBO, to at least consider using a fraudulent conveyance action as negotiating leverage.

With few completed cases, no widely accepted approach for analyzing the financial aspects of allegedly fraudulent transactions has emerged. Financial advisors engaged in these cases should analyze transactions from a variety of perspectives to allow for different legal interpretations.

Before discussing financial analysis techniques, it is necessary to understand the basic fraudulent conveyance statutes. According to the U.S. Bankruptcy Code, fraudulent conveyances have the following characteristics:

The debtor received less than reasonably equivalent value for transferring an interest or incurring an obligation, and: was insolvent at the time of the transaction or was rendered insolvent as a result of the transaction; was left with insufficient capital to conduct its business; or incurred debts that it was unable to pay as they became due.

In an LBO, the company being purchased typically assumes debt for a substantial portion of the purchase price, but the proceeds do not remain with the company. This has been construed to mean that virtually every LBO meets the "less than reasonably equivalent value" criteria. As a result, financial analysis, in fraudulent conveyance transactions involving LBOs, should focus primarily on the company's solvency at the date of the transaction and on the adequacy of the company's capital to conduct its business and service its debt.

Insolvency:

Under the Uniform Fraudulent Conveyance Act, a company is deemed insolvent "when the present saleable value of its assets in a reasonably prompt sale is less than the amount that will be required to pay its probable liability on its existing debts as they become absolute and matured." Some common valuation approaches used to assess solvency follow:

Valuations, based on Generally Accepted Accounting Principles ("GAAP"), are predicated on the theory that for the purpose of establishing an opening balance sheet, following an acquisition, GAAP requires assets (excluding goodwill) to be valued at the lesser of their fair market value or the purchase price. As a result, if the GAAP value of assets (excluding goodwill) exceeded liabilities at the transaction date, it can be argued that the company was solvent. There are two problems with this argument:

First, the fair market value of assets measured under GAAP is not always reflective of the "present saleable value of assets in a reasonably prompt sale."

Second, courts have allowed the benefit of hindsight in the measurement of contingent liabilities present at the transaction date. GAAP valuation of such liabilities, on the other hand, is based on the likelihood that the contingencies will mature and on a minimum estimate of the amount that would be due.

Estimates of orderly liquidation value can be tailored to follow the definition under the Uniform Fraudulent Conveyance Act. However, it is important to recognize that assumptions underlying such valuations can easily be challenged, especially since such valuations are often performed months, or even years, after the transaction date.

Going concern valuations typically estimate the value of a company's assets based on their ability to generate earnings and cash flow. While these valuations are most widely accepted in evaluating transactions, they can be very difficult to support, primarily because:

These valuations reflect projections prepared at, or prior to, the transaction date of the company's prospective earnings and/or cash flows, and use assumed discount rates or earnings multiples. Assumptions underlying the projections, discount rates and earnings multiples are all susceptible to attack.

Considering that defendants often prepare analyses months after the transaction, to support assumptions used in projections which were prepared prior to the transaction, this method carries the additional burden of arguing that the assumptions were reasonable when hindsight often indicates that, in fact, the assumptions were optimistic.

Adequacy of Capital:

Analysis to assess the adequacy of capital should focus on several issues with regard to pre-transaction prospective financial statements.

Assumptions used in estimating the prospective financial performance of the company should be compared with the company's historical performance. Management's business plans and their comments on historical performance should also be considered.

Seasonality of the company's business should be analyzed to assess whether post-transaction financing reasonably accommodates seasonal business fluctuations.

The final deal structure should be compared to that assumed in the pre-transaction financial projections, considering implications of last minute changes in transaction and financing terms. The risk that the company may violate its debt covenants, or be unable to meet its debts as they became due, should be evaluated based on final financing terms.

If the analysis is being performed after the transaction, possibly as a defense, changes in the business after the transaction date should be analyzed to evaluate whether the failure was attributable to causes that could not have reasonably been predicted.

Summary:

How should participants in transactions approach these issues? Whether one is evaluating a transaction prior to its completion, or years later, it is prudent to consider each of the issues discussed above.

Projections used to evaluate transactions are critical in assessing both capital adequacy and solvency. Assumptions and business strategies underlying pre-transaction projections should be carefully thought out and properly documented. Performing adequate due diligence prior to the transaction and having an independent party analyze projections can go a long way toward lessening the likelihood of a fraudulent conveyance action later.

Although a thoroughly prepared contemporaneous analysis will be easier to support than an analysis developed years later, it is still possible to develop defendable post-transaction analyses. In such cases it is important to perform each analysis under several sets of assumptions to evaluate the sensitivity of the analysis to the assumptions utilized.

— NCR, March 1993

National Health Care Reform

By Charles T. Day

In unveiling his long-awaited plan for health care reform, President Clinton has touched off a storm of public and political debate likely to surpass any that we have seen in recent years. But, as the debate rages on, the basic premise is that it will be about working out the specifics of a legislated reform plan — not whether there is a need for health care reform. For those who are part of the health care delivery system, there are enormous systems and cash flow implications from reform, beginning with the fact that it will occur faster than many had anticipated. Several areas of reform also pose new challenges for professionals advising hospitals, physicians and health care organizations.

Medicaid/Medicare cap savings

According to the plan, Medicare and Medicaid caps will be a major component in financing universal health care. Over five years, the plan calls for, and the administration is standing by its estimates of, a combined savings of $238 billion from Medicare and Medicaid expenditures. With billions less going into the system, health care providers that have a significant portion of Medicare/Medicaid patients can certainly expect their margins, which are already under attack from market pressures, to contract further. By holding down revenues, the caps will accelerate and intensify the effort many institutions are already making to downsize or "re-engineer" the way they provide health care in order to protect cash flows.

Information technology

In an environment increasingly characterized by managed competition, and soon to be replete with capitated managed care contracts, providers will have to capture, track, compare, analyze and report data as never before. Only with solid information on costs and medical outcomes can they manage the risks and rewards of capitation, as well as respond to new government regulations. While hospitals have been improving their information management capabilities, reform will require that they push ahead farther and faster. In the short term, the need to collect data and put new information systems in place, may make it desirable to involve outside advisors with concentrated, relevant experience.

Actuarial capabilities

In a health care world based on capitated contracts, actuaries will play an increasingly important role as they translate mountains of data into critical pricing decisions. This will drive increased actuarial capabilities, if not within individual hospitals, within the integrated model chosen to face this new world. It is no exaggeration that in the new health care world, actuarial input will have the power to make or break a proposal. There is already clear evidence of this from states that are working with implemented managed competition models.

Incentive compensation systems

To deal with the changes under way, hospitals will also have to develop new and different reward systems. The notion of rewarding on the basis of increased volume and a hoped-for increase in revenue and improved bottom-line is essentially being turned upside down in a capitated, cost conscious health care environment. Compensation systems will now have to reward people both for managing volume decreases and for making improvements on the expense side of the income statement. Further, in many cases, people will and should be heavily rewarded for qualitative, rather than quantitative, factors.

Reimbursement and financial reporting and planning

As long as the system is such that reimbursement payors will allow for the impact of downsizing and other changes, there may be an opportunity for hospitals that plan ahead for the change to a managed competition environment. It is unclear how much and which of the dislocation costs the reimbursement system can cover, but many hospitals feel that a system they know is better than one they don't. And, in general, it seems clear that the current reimbursement system is more conducive to downsizing and other implications of managed competition on an infrastructure basis than what we are likely to see in the future.

In terms of financial statements, hospitals will need to begin thinking about the rules relating to recording reserves and accruals to reflect the effects of downsizing and other responses to the competitive forces in the marketplace. While this may be seen as a sensitive matter for each institution, management is probably better off to not avoid such deliberations now, so the institution will be able to react when the time is right.

Cultural change

Virtually all health care providers whether they are tax-exempt or taxable will face a wide range of new and difficult issues ranging from creating and managing networks or alliances to pursuing consolidation opportunities and aggressively restructuring their organizations. The focus for most people in the field has been on the technical side of their business, not on the dynamics of cultural and organizational change. As health care reform shifts into high gear, hospitals and physicians will need to accelerate their schooling when it comes to dealing with organizational and cultural change.

In many ways, September 22, 1993 was a turning point in the history of health care in this country. By establishing the scale and timetable for reform, the president has defined the challenges that the health care community and, in particular, hospitals and physicians will face in the crucial months ahead. Now, more than ever, it's a matter of how and how well they will stand up to these challenges.

—NCR, November 1993

Bankruptcy Amendments Act of 1993 — *Pensions Down; Torts On Hold; Costs Up*

By Wendell H. Adair

On September 15, 1993, the Senate Judiciary Committee unanimously approved an amended version of Senate Bill 540, the Bankruptcy Amendments Act of 1993 ("S.B. 540"); thus advancing the bill for approval by the Senate. This article examines the major amendments and their impact on business reorganization cases.

No Preference for Pension Claims

The most significant amendment to S.B. 540 eliminates the proposed section on pension plan contributions. The original S.B. 540 contained a provision that would have required chapter 11 debtor companies to make minimum pension plan contributions during the pendency of their bankruptcy cases. Such contributions could only be postponed by an order of the bankruptcy court upon a showing that the interest of the estate required such postponement. In any event, such contributions will have to be paid no later than (i) the effective date of a plan of reorganization; or (ii) the conversion of a case from reorganization to liquidation. Postponed contributions would have been collateralized by security interests in the debtor's corporation assets and would bear interest until payment.

A similar pension plan contribution provision was in the bankruptcy amendments bill presented last year that passed the Senate, but was not acted on in the House prior to the end of the term. The elimination of this requirement removes what would have been a significant obstacle to the reorganization of corporate debtors and prevents the further obstruction of the "level playing field" for corporate creditors.

No Mass Tort Provision

Although it has been the subject of much debate, a draft proposal concerning mass tort liabilities (commonly referred to as the "Manville provision") was not included in the amended S.B. 540. This provision proposes to allow chapter 11 debtors to create trusts that would administer mass tort claims and administer assets devoted to satisfying such claims. In addition, bankruptcy courts would be authorized to permanently enjoin such tort claims from seeking payment from reorganized debtors. This solution to mass tort liabilities was adopted — without specific statutory authority — in the Johns-Manville Corp. bankruptcy case in resolving asbestos personal injury claims by channeling such claims into a trust funded by a combination of cash and stock of the reorganized debtor. The Senate Judiciary Committee took testimony on the draft provision from industry groups and the tort plaintiff's bar. The principal arguments in favor of this provision are (i) it will increase the predictability of debtors' business operations thereby aiding the reorganization process and (ii) it will allow a more equitable payout by providing a method to fund future claims. Opponents of this provision argue that it allows debtor companies to undervalue the amount of mass tort claimants and underfund the trusts, which will require restructuring of the trust, a problem illustrated by the Manville Trust. The Senate Judiciary Committee was unable to reconcile these positions and unwilling to delay the bill, although it is possible that the draft proposal will be raised before the full Senate during debate.

Greater Allowable And Administrative Costs

The costs of administering a chapter 11 case will increase due to certain amendments to S.B. 540. First, the original S.B. 540 resolved a split among various courts by changing section 503(b) of the Bankruptcy Code to authorize the reimbursement of the actual, necessary expenses of committee members. The amendment goes further by authorizing the reimbursement of legal and accounting fees and expenses incurred by individual committee members. Second, the amendment to S.B. 540 rewrites section 362(b) of the Bankruptcy Code to authorize a government unit to (i) issue a notice of tax deficiency or demand for tax returns; (ii) conduct a tax audit; or (iii) assess an uncontested or agreed upon tax liability without seeking relief from the automatic stay imposed at the filing of a bankruptcy case.

Trade Creditors Lose

Trade creditors lost a significant proposed increase in their protection for credit extended in shipping goods to troubled entities. The amendment to S.B. 540 removed a provision which would have changed section 546(c) of the Bankruptcy Code to extend the period during which a supplier may reclaim goods from 10 days to 30 days. In addition, the amendment to S.B. 540 clarifies that under the proposed new section 546(h) of the Bankruptcy Code, the debtor may, with the creditors consent and court approval, return goods shipped by a creditor before the commencement of the case and may offset the purchase price of the goods against the creditor's claim. As originally proposed, this section 546(h) would have allowed a debtor to offset only the value of the returned goods.

What Comes Next

The amended version of S.B. 540 currently has 29 co-sponsors consisting of 14 Democrats and 15 Republicans; therefore, it is likely to be approved by the Senate. The current session of Congress is set to expire in late December, giving supporters of bankruptcy reform legislation more time than last year to secure approval by the House and resolve any differences between the two legislative bodies. Copies of the amended S.B. 540 marked to show the amendments are available upon request.

—NCR, November 1993

Senate Repeals Stock-for-Debt Exception

Could Change the Way People Do Turnarounds

By John Wm. Butler, Jr. and Kathleen Ninivaggi

Included in the Revenue Reconciliation Bill of 1993 (S. 1134) passed by the Senate in late June without any public hearings or debate on its implications was a repeal of the stock-for-debt exception to determining income from the discharge or cancellation of indebtedness ("COD Income"). The House version of President Clinton's budget package does not contain a similar repeal provision. At press deadline, the two bills were to be reconciled by a joint conference committee, which was expected to convene beginning on July 12, 1993. If the repeal provision is retained by the joint conference and is enacted into law as part of the President's budget package, the repeal would be effective generally for Chapter 11 cases filed after June 16, 1993 or out-of-court restructurings for which there had not been a binding contract or SEC filing as of that date.

While, as a general rule, gross income includes COD income, as a matter of policy favoring the rehabilitation of debtors, if the discharge of indebtedness occurs in a bankruptcy case or while the taxpayer company is insolvent, COD Income is excluded from taxable income but the debtor must reduce certain tax attributes to the extent of the COD Income.

In the early 1940s, courts developed an important exception to the general treatment of COD Income under which no COD Income was triggered if a debt was exchanged for stock of the debtor.

Pursuant to this "stock-for-debt" exception, a company, solvent or insolvent, repurchasing its own debt by issuing stock to its creditors was not required to recognize COD Income or reduce its tax attributes. Essentially, the stock transaction was viewed as simply a change in the form of the same investment. In 1984, in response to a number of transactions in which solvent companies structured investment transactions as debt-for- equity swaps in order to avoid substantial tax liability through the stock-for-debt exception, Congress restricted the application of the stock-for-debt exception to bankrupt or insolvent debtors. The continuing application of the stock-for-debt exception to bankrupt or insolvent companies is based on the fundamental principle that once insolvent, a corporation's creditors, in an economic sense, succeed to the equity interests of the company. The Senate-approved repeal of the stock-for-debt exception will force bankrupt and insolvent debtors that issue stock to their creditors in partial or complete satisfaction of debts to reduce their tax attributes to the extent of their COD Income.

The Ad Hoc Alliance To Preserve Stock-For-Debt Provisions of the Tax Code, which includes the Association of Insolvency Accountants and the National Bankruptcy Conference, is concerned that corporate renewal attempts will be severely jeopardized by the elimination of the stock-for-debt exception. The Alliance estimates that the average enterprise value of restructured companies would be reduced by 8-10% and that restructured companies would have to increase net revenues by 50-70% in order to both repay restructured debt and the tax liabilities created by loss of tax attributes used up by the COD Income.

Mandating that insolvent debtors reduce their tax attributes by COD Income attributed to stock-for-debt transactions completely disregards the role of net operating losses and other tax attributes as important assets of reorganizing debtors. In many cases, reorganizing debtors rely on the ability to exchange equity interests in the reorganized company for the partial or complete satisfaction of certain of the claims against it. If debtors are forced to deplete their tax attributes, the value of the exchange will be reduced, requiring either additional assets for the satisfaction of senior claims with corresponding impairment of junior claims or resulting in failure of the reorganization attempt and liquidation.

Advocates of the stock-for-debt exception argue that the exception should be saved because (1) it is frequently the linchpin for saving the jobs in troubled businesses and avoiding business liquidations at distressed prices; (2) the federal government may well have a revenue loss if there is a repeal because of the lost taxes not paid by displaced workers and suppliers; (3) banks and other lending institutions benefit from financially stronger enterprises in their loan portfolios; (4) repeal will encourage employers in workouts and Chapter 11 cases to issue debt instead of stock, so they can use interest deductions to offset taxable income; and (5) reorganized companies will have more money to purchase equipment and inventory to rehabilitate the business.

On June 11, 1993, the TMA Board of Directors passed a resolution in support of the retention of the stock-for-debt exception as a tool in the crucial role of preserving jobs through reorganization as opposed to liquidation.

In connection with this action taken by the Board of Directors, a letter has been sent to members of the House Committee on Ways and Means, the members of the Senate Finance Committee and the staff of the Joint Committee on Taxation which encourages a change in the legislation to retain the provision.

At press time, the TMA Legislative Action and Public Affairs Committee was scheduled to meet in Washington, D.C. on July 15, 1993 during the joint congressional conference committee meetings to address the stock-for-debt exception as well as an amendment to IRC § 108 that would defer COD Income in secured real estate restructurings if the basis of the secured realty is reduced by the amount of the debt forgiven.

If this legislation is passed as written its impact will most certainly be to fundamentally change the way that people do turnarounds. We will continue to monitor and report on the progress of this important legislation.

—NCR, July 1993

Stock-for-Debt Exception Repeal *(Follow-Up)*

While the TMA cooperated with a coalition of accounting firms, insolvency organizations, unions and corporations which actively worked to avoid the repeal of the stock-for-debt exception, the exception to the Internal Revenue Code was repealed as part of the Revenue Reconciliation Bill of 1993. Following submission of a fact sheet and "white book" to which TMA contributed, the final deficit reduction package was amended to delay repeal of the exception until 1995 (although the exception will be permanently retained for entities filing Chapter 11 cases by December 1, 1993).

The Coalition is still concerned that corporate renewal attempts will be severely jeopardized by the elimination of the stock-for-debt exception. Coalition accountants estimated the average business value of restructured companies would be reduced 8-10% and that restructured companies would have to increase net revenues by 50-70% in order to both repay restructured debt and the tax liabilities created by loss of tax attributes used up by the COD income. The coalition is now actively working on reversal of the 1995 repeal.

TMA members who desire to participate in this effort should contact TMA Legislative Action and Public Affairs Committee Chair Jack Butler at (312) 407-0730 or Vice-Chair Debbie Devan at (410) 332-8834.

—NCR, September 1993

Fiduciary Duties to Creditors Upon Insolvency

By Wendell H. Adair and Michael L. Boykins

In recent years, directors of troubled companies have become increasingly concerned with the scope of a director's fiduciary duty to creditors. The general rule of law is that directors do not owe a fiduciary duty to creditors, beyond any relevant contractual agreements, absent special circumstances. Those "special circumstances" have traditionally included fraud, insolvency or violation of a statute and, in at least one case, dissolution.

While the general rule of law with respect to a director's fiduciary duty to creditors is fairly settled, the scope of that rule has been the subject of much discussion. In a 1992 Delaware case, Geyer vs. Ingersoll Publications Co., the court addressed the scope of a director's fiduciary duty to creditors upon insolvency, and at what point insolvency would be measured.

The Ingersoll case involved a Delaware newspaper publishing corporation. The plaintiff, a creditor of the corporation and a former partner of the defendant, alleged that the defendant, a director of the corporation, breached his fiduciary duty to the plaintiff by surrendering its major assets to third parties for his personal benefit. The plaintiff argued that the corporation was insolvent prior to these transfers because it had failed to make several interest and principal payments on a $2,000,000 promissory note held by the plaintiff and as a result, directors of the corporation were required to consider the impact of the transfers on the interests of creditors. The plaintiff argued further that insolvency in fact should be the trigger giving rise to a director's fiduciary duties to creditors and not the institution of a statutory insolvency proceeding.

The defendant argued that a director's fiduciary duty to creditors should occur only by reference to a clearly definable objective criterion. Therefore, a director's duty to creditors would not arise at the moment of insolvency in fact but, instead, upon the filing of a statutory insolvency proceeding. The defendant emphasized the importance of providing directors with "a clear and objective indication as to when their fiduciary duties to creditors arise" in order to avoid unduly burdening the decision making process of directors.

Although acknowledging the benefits of a clear and objective rule, the court in Ingersoll held that the fiduciary duty of directors to creditors was triggered at the moment of actual insolvency rather than upon the filing of a statutory proceeding. The court cited an earlier Delaware decision, Bovay vs. H.M. Byllesby & Co., which stated that "the fact which creates the trust [for the benefit of creditors] is the insolvency, and when that fact is established, the trust arises, and the legality of acts thereafter performed will be decided by very different principles." The court stated that Bovay, and the cases cited therein, clearly indicated that Delaware case law does not require the institution of a statutory proceeding to trigger a director's fiduciary duty to creditors. In addition, the court stated that the dictionary definition of "insolvency" referred, not to statutory proceedings, but to an entity's inability to pay its debts as they fall due in the ordinary course of business (i.e., an entity's liabilities are in excess of the reasonable market value of the assets held). Thus, the court concluded that the use of the term "insolvency" in the general rule of law did not suggest that statutory proceedings were necessary.

In reaching its conclusion that a director's fiduciary duty to creditors arises at the moment of actual insolvency, the court also addressed public policy issues. The court stated that the "existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group . . . at a point in time when shareholders' wishes should not be the directors only concern." Further, the court stated that the occurrence of the fiduciary duty upon actual insolvency would relieve creditors of the burden of having to speculate as to when directors are entering into transactions that would render the corporation insolvent.

It is important to note that the court in Ingersoll did not specify what was meant by the phrase "moment of insolvency" nor did it address the substance of a director's fiduciary duty. The court did suggest, however, that the "fiduciary duties to creditors arise when one is able to establish the fact of insolvency."

Although the Ingersoll case was decided in the Court of Chancery of Delaware, it is likely to have broad national application because of the large number of corporations incorporated in the State of Delaware and because other states often follow decisions of Delaware courts when interpreting and deciding issues in the corporate area. As a result of the decision in this case, directors of a troubled company may find themselves with a fiduciary duty to creditors when the company actually becomes insolvent, rather than, as most directors had previously assumed, upon the institution of a bankruptcy proceeding.

—NCR, March 1993

RTC's Casey: "$25 Billion Will Finish S&L Cleanup"

Washington Post excerpt

Albert V. Casey, head of the thrift cleanup effort said "We can sunset the whole thing by the end of 1993," reducing by nearly half, the remaining cost predictions — down to $25 billion. His estimate of $112 billion total cost, is well below the $130 to $160 billion figure the Treasury has stuck to.

The RTC has taken over 727 failed S&L's in the past 3 years, shutting the doors, paying off depositors and selling their loans, real estate and other assets.

In 1992, RTC sold $100 billion in assets and plans to sell another $70 billion this year, leaving $20 billion in hard-to-sell assets. Casey said "sales could have been significantly more, had Congress not voted down the funding bill in April."

—NCR, January 1993

Financial Advisors Subject to Increased Scrutiny

By Wendell H. Adair

In a series of recent orders, bankruptcy judges have begun to subject the hiring of financial advisors to increased scrutiny. Beginning in 1991, Judge Paskay in the Middle District of Florida suggested that the world of investment banking "is indeed a strange, but wonderful place where a large amount of money is spent, generally at the expense of debtors in Chapter 11." Likewise, Judge Conrad in the Southern District of New York observed "Whenever we have dealt with investment bankers and financial advisors we have been left with the strong impression that for them the debtor is the cash cow to be milked, Chapter 11 the milking parlor, and the Judge the milking stool."

It is in this context that in a decision issued by Bankruptcy Judge William C. Hillman in the Wang Laboratories Case, the Debtor in Possession was not permitted to hire Smith Barney as its financial advisor.

Judge Hillman's August 26, 1992 order stated that he was not persuaded that the employment of a financial advisor was "either necessary or in the best interest of the Debtor's estate." In reaching this conclusion, Judge Hillman noted that the Debtor had previously obtained court approval for the retention of both legal counsel and accountants. He went on to suggest that most if not all of the proposed financial advisor services would be duplicative of the services performed by the Debtor's legal counsel and accountants.

Judge Hillman noted further, that while the Debtor might gain some benefit from the retention of a financial advisor, that benefit would be severely offset "by the tremendous expense to the state of hiring the investment banker." Under its agreement with Wang, Smith Barney was to be paid a monthly cash fee of $175,000. In denying Wang's employment of a financial advisor, the judge observed that the recent proliferation of investment bankers/advisors to the big Chapter 11 cases had generated a growing trend of disfavor among bankruptcy judges. Specifically, he noted that financial advisors were not subject to the same stringent fee reporting requirements placed upon attorneys and similar professionals employed by the Debtor.

Subsequent developments have determined that Judge Hillman's primary objection was Smith Barney's unwillingness to work on an hourly basis subject to court review in the same fashion as attorneys and other professionals. Indeed, Judge Hillman recently approved the retention of Donaldson, Lufkin & Jenrette by Wang when they agreed to work on an hourly fee basis. In its fee application, DLJ stated that it would charge $425.00 per hour for a managing director or principal, $375.00 per hour for a senior vice president, $300 for a vice president, $250 for an associate and $175 for an analyst.

The DR Holdings case in Delaware is another example of financial advisors being subjected to greater scrutiny. In that case, the court approved the appointment of both a junior and senior creditors committee. When these committees moved for the hiring of separate financial advisors, Judge Balick denied their request. Instead, she ordered that the two committees jointly propose the retention of one financial advisor. After weeks of extensive negotiation, the two committees have tentatively agreed upon the retention of an accounting firm and the methodologies to be used by the accounting firm in providing written answers to written requests for specific calculations.

Obviously, these orders raise serious questions which have generated a great deal of debate within the investment banking field. Whether these orders represent a new trend or are merely exceptions to established practice remains to be seen.

Turnaround professionals are compensated in many different ways. Some, like attorneys and accountants are paid by the hour. Others are paid success fees, equity or on a monthly or two week retainer basis. These cases suggest that hourly arrangements are more likely to be approved by bankruptcy judges.

—NCR, January 1993

Prohibited Discrimination or Comprehensive Legislation?

By Wendell H. Adair

In one sense, the Americans With Disabilities Act (ADA) is simply another category of prohibited discrimination engrafted onto existing federal civil rights legislation. In another sense, the statute is the most comprehensive piece of legislation dealing with the problems of a "minority group" that has ever been enacted. Indeed, the ADA covers not only employment discrimination but also commercial discrimination that results from architectural barriers to access to businesses and public accommodations. And it may be the first set of laws that requires the collaboration of real estate and employment lawyers.

Passed in July 1990, the ADA was given a rather extended phase-in period. In January 1992 the public accommodations provision became effective. In July 1992 the employment discrimination provision became effective for employers of 25 or more. In July 1994, the provision goes into effect for employers of 15 or more.

The public accommodations provision paves the way for "commercial facilities" (factories, warehouses, office buildings, and other buildings where employment may occur) and "public accommodations" (just about any facility that affects commerce and invites the public for business) to remove architectural barriers and make achievable changes to ensure the equal enjoyment of such facilities by the disabled. A supermarket, for example, may be required to provide alternative means for visually impaired persons to shop. The obligation to make the changes may depend on ownership of the real estate or the nature of the leasehold.

Under the employment provisions of the Act, an employer cannot discriminate in hiring, discharge, or any term or condition of employment against a qualified individual with a disability who, with or without reasonable accommodation, can perform the essential functions of the position. The italicized words are key concepts that are defined and explained in the statute and comprehensive regulations.

Any employment decision against a disabled individual must be job-related and consistent with business necessity. An employer can also base an employment decision on the threat to the health or safety of others in the workplace. Given the myriad of job situations at the hundreds of thousands of employers covered, ADA necessarily will require substantial court interpretation.

Not protected under the Act are individuals using illegal drugs, except those who are participating or have participated in a rehabilitation program, or those who are erroneously regarded as illegal drug users, when the employer bases its decision on illegal drug use. An employer may also hold an alcoholic or drug user to the same standards of performance and behavior as other employees. Transvestites, homosexuals, and bisexuals also are not protected under the ADA.

Employers are permitted to require pre-employment physical examinations under the ADA if 1) all employees are required to undergo a pre-employment physical, 2) the medical information is kept confidential and in a separate file, and 3) the results of the physical are used to determine the individual's ability to perform job-related functions. The employment provisions of the ADA are enforced by the Equal Employment Opportunity Commissions in the same fashion as Title VII of the Civil Rights Act of 1964.

—NCR, May 1993

CALLING ALL DOLLARS!

Beyond the Crisis . . . What's Next?

By John M. Collard

Dollars come and dollars go . . . in and out of a company . . . preferably more of the former.

Remember, a company is in business to make money. If this is true, and most will agree, then you must consider the basic elements in the equation — Revenue, Direct Cost, Overhead and What's Left Over . . . Profit. When nothing is left over, the company has a real problem. We've all seen enough of these.

You can increase the revenue, cut direct costs and overhead or throw in the towel. When giving up isn't the answer, what about cutting costs? While this maneuver is certainly helpful, it is not always the complete solution, besides there is a limit to which costs can be cut. To create a long-term fix for a troubled company, the only viable alternative is to increase the revenue. The ***when*** is now. But how? And from where?

Sometimes, the solution to the revenue problem can be obvious. I once went into a manufacturing company that was in real trouble and losing money, but had no idea why. The company had 280 employees, 24 of which were in the accounting department and only three were in sales. Those salespeople weren't selling anything . . . get the picture?

But frequently, the reasons behind a revenue shortfall are more complicated. And solving the problem can be difficult.

The crisis is over, the company is stabilized and you've developed a short-term plan. Now you must turn to the long-term viability of the company to create value for the stakeholders. *But will that be allowed?* The bank wants out. Crisis managers brought in during the early dark hours often say "...the job is done" and exit. This leaves the management team to wonder what happened and what to do next. If the turnaround process short-circuits at this point, the company faces a stiff climb out of the ashes. And most never make it.

"A dollar must become a dollar of revenue before it can be considered any other kind of dollar."

For the business to be successful, all stakeholders including lenders, creditors, customers, suppliers, shareholders, directors, advisors, the leadership and employees in the company must believe that it can be a winner. All parties involved must agree that the company is worth saving. This will, by their actions, require each of them to make a commitment to a process that may take awhile.

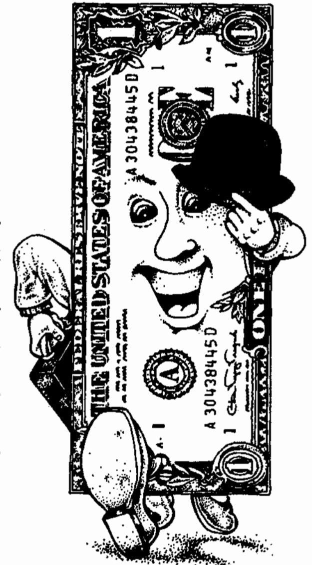
Rebuild the company! Restore it to a vibrant state . . . then the value will come back to what once was a dying entity. The only way to provide a foundation on which to build is to generate revenue. A dollar must become a dollar of revenue before it can be considered any other kind of dollar.

Know Your Customer

When is the last time that you talked with your customer? What does he think about your products and services? Why does he buy from your company? Are you satisfying his needs? What improvements would he like to see?

The most important step toward revenue rejuvenation is to understand your customer. Determine what your customer values, in what context he values it and how he measures that value. Your customer must derive benefit from your products and services or he won't buy them.

By identifying what your customer needs, you gain a better understanding of how to market your product or service. Understand what your customer is trying to accomplish. More importantly, understand how your product or service helps him accomplish it.



Learn how your customer measures value. Is it increased profits, cash flow, problem avoidance or convenience? Assist him by detailing what your product or service can do to help your him sell his product or service. What advantage do you offer to your customer? Do your products or services make your customer more efficient and productive? Can he save costs in other areas because of your product?

Be aware of what motivates the customer to buy. Do your products or services provide special benefits or features to the customer? Are they able to generate more profits?

It is also imperative to address the real issue of how customers perceive the company and its products or services relative to the competition. What are your product's or service's strengths or weaknesses? Are they accurately understood by your customer? Implement a marketing plan that informs your customer and motivates him to purchase.

Understand the customer's buying process. Before the purchase can be consummated, the customer must have a *need* (pain) to be satisfied, you have reached a decision maker with *authority*, the customer's *budget* is available, and it is a *priority* and fits within an acceptable timeframe.

Adapt Your Company

A soul-searching look inward to the organization's goals, strategies and distinct competencies is essential. It's not the way the company looks at itself . . . it's the customer viewpoint that counts. Perception is the key. It has many sides . . . to confuse your competition . . . to benefit and comfort your customer . . . to fool yourself.

To get an accurate picture of a company's current revenue health, look at where and how revenue historically has been generated. Is it from existing customers and contracts or new business? It is six times easier to sell products and services to an existing satisfied customer than it is to go through the prospecting cycle to add a new customer. Where are you spending your time? How many new orders are being generated? What is the average revenue per employee? How does this compare with the industry norm? More importantly, which direction is the ratio going? What is the average revenue per job or unit sold? Is it competitive?

The "Volume In," those sales that can be booked as revenue, goals must contain sufficient optimism to be a target that salespeople want to achieve, yet revenue and sales projections must be realistic and attainable.

Try to set a projection range with *worst, likely* and *best* case scenarios, being careful to understand what parameters can be influenced to accomplish the best case. *(Continued on next page)*

Specific Considerations in a Troubled Company

By Paul F. Barnes

The successful reorganization of a troubled company is dependent upon changes and improvements in several areas including operational, structural and financial. Critical to the optimization of the financial component are cash maximization techniques including proper tax and valuation planning. Preserving a company's net operating loss (NOL) carryovers and minimizing the recognition of cancellation of indebtedness (COD) income can enhance the company's cash flow following a debt restructuring. However, careful tax and valuation planning must be employed to ensure that these benefits are achieved.

Generally, the discharge of debt gives rise to taxable income in the amount of the debt forgiveness to the debtor. However, if the debtor is insolvent at the time of debt restructuring, it may exclude COD income to the extent of the insolvency. Current tax law under Section 108 defines insolvency as the excess of liabilities over the fair market value of assets with the determination made on the basis of the assets and liabilities immediately before the discharge.

In such situations, the determination of the fair market value of assets in the context of determining insolvency poses several valuation questions not encountered in the typical valuation of a healthy company:

What is the premise of value, going concern or orderly liquidation?

Depending on the degree of insolvency as measured prior to the debt restructuring, a going concern valuation based on prospective cash flows and existing debt levels may show that the cash flows are insufficient to provide a fair rate of return on the net investment in tangible assets. In such a case, an orderly liquidation valuation may provide a more appropriate assessment of the value available to all stakeholders.

Should transaction costs that would be incurred in a disposition of the net assets (equity) be recognized in the valuation?

Although such costs are generally not considered in a valuation, the legal theory underlying the exclusion of COD income for insolvent taxpayers is based on the proceeds that would be available to creditors upon the sale of the taxpayers' assets (the freeing of assets theory). Thus, transaction costs, including taxes, would be considered in determining net realizable value.

Should tax attributes such as NOL's be treated as components of value in the determination of total asset value?

Yes they should, but the quantification of this benefit becomes an iterative process since the exclusion of COD income may reduce the magnitude of available NOL's.

To what extent, if any, should contingent liabilities be incorporated in the fair market value of net assets computation?

Although relevant case law may indicate that contested liabilities should not be included, contingent liabilities should be accounted for either directly or indirectly through the selection of the discount (or capitalization rate).

What adjustments need to be made to market multiples and discount rates gleaned from publicly traded comparable companies before application to the troubled subject company?

In this case, rates of return and multiples expected by "vulture funds" on debt and equity investments may be more indicative of the unique risk/return characteristics of troubled companies.

These are but a few of the many unique valuation issues attendant to a tax insolvency analysis. A careful analysis of these and other factors as well as the particular facts of the subject company is imperative in order to optimize the tax planning and cash flow posture of a company contemplating a debt restructuring.

—NCR, May 1993

Calling All Dollars *(Continued)*

The "Volume Out," your manufacturing production or throughput, is a function of sales volume and inventory available for shipping (if applicable). Remember, you must get the product out the door before it can be included in revenue, hence in accounts receivable and in turn create cash.

Consider what sets you apart from your competition. Know what are your key competencies — your special capabilities — and develop them. Keep in mind, you can't be all things to all people — don't try to.

It is also crucial to take a good hard look at the company's products and services to determine if they are meeting the existing demand in the market that your customer has confirmed. You'd be hard pressed to sell many buggy whips in today's marketplace. By the same token, it can be a losing proposition to try to exploit a futuristic product or service that does not have a tangible niche in today's market. You might save this strategy for a time when the company has fully regained its health.

"Determine what your customer values, in what context he values it and how he measures that value."

Along with product and service viability, the cost to your customer must be in line with what the market will bear. It is the nature of the engineer to want to create a "Rembrandt" — something special that meets the needs of all customers. This approach can only add to the cost of the product, often a markup that the customer is not willing to absorb. Keep the "bells and whistles" to a minimum, and if possible, consider offering product pricing options. Using a modular approach, for example, for technically-oriented products will allow a better fit with various customer profiles by providing a pick-and-chose option.

Your business should be geared to your customer's needs — not yours. Make it easy for your customer to buy from you. Are you conveniently located? Are your hours of operation sufficient? How easy is it to contact your salespeople? Do you offer convenient payment terms?

Do What It Takes To Bring In New Business

A business in trouble not only faces dwindling revenues but often declining employee moral as well. In troubled times, employees worry about their job security and productivity suffers. You must re-establish motivation to get things moving again. Employees need to believe that they can make a difference.

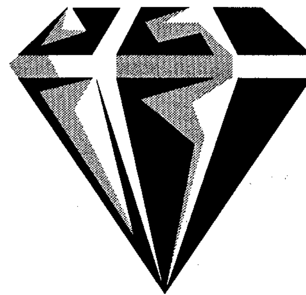
Instill a "we-will-do-what-it-takes" attitude toward developing new business. This is a sure-fire method to breed success. To be certain, this is easier said than done, but it is prerequisite if you want to prosper. Develop a commitment to winning new business and make sure management gets involved in the business development process.

Set the directive and the goals. In turn, offer incentives to motivate employees top to bottom. These rewards should be based on performance — the performance that you want — and should be paid when goals are achieved and not awarded if they are not fulfilled. Be fair, but hold people accountable. Consider paying management-level employees incentives based on gross margins rather than gross sales thus ensuring that they will have a vested interest in increasing revenue at profitable margins.

Resurrecting a troubled company requires building a solid foundation . . . rooted in the most basic part of the equation . . . the company's ability to generate revenue. As long as a business can generate revenue, it can bring value to the stakeholders. It requires knowledge . . . of your customer . . . of your company . . . and of what you are capable of doing. Only then will the dollars come marching in.

—NCR, July 1993

Diamonds in the Rough



By Kamal M. Advani & Dale A. Buckwalter

Companies operating in or at the brink of bankruptcy often appear to the would-be buyer as a diamond in-the-rough needing only the skillful hand of an artist to transform it into a valuable gem. But trying to extract this thing of beauty can be a very risky proposition. It demands nerves of steel and the willingness to endure a tortuous process which requires that even the most experienced acquiror be willing to go an extra mile and cover seemingly insignificant details.

Sometimes it's worth the trouble. An acquiror that can remain unattached, unemotional, realistic and always willing to walk away from the deal can land a gem of a business at a bargain price. Here are a few "diamond cutting" tips that can help:

Be Realistic About Your Capabilities

During the process of evaluating and valuing a troubled company, the buyer may naturally assume that the incumbent management of the target is inept in certain respects and that the Company's poor performance is directly attributable to management's inabilities. Notwithstanding the correctness or incorrectness of this assumption, the buyer may be further inclined to assume that it can easily make a series of rapid, substantial changes in order to improve the target's post-acquisition performance.

Such assumptions are generally fraught with error. New management and new ideas do, in fact, often rejuvenate old and tired businesses, and many buyers acquire a company with that in mind. However, if the seller has had many years of experience in the industry, chances are that some of these new ideas have already been tried and have failed, or have been considered but not implemented for sound business reasons. Even if the acquiring company is correct about the need for change and the critical change elements (and this is a major assumption) such a restructuring generally takes longer and is more expensive and painful than even the most experienced buyer could have predicted.

One critical element often overlooked in this regard is that a needed and necessary change in personnel can often create a concern among other key people who may subsequently leave the company as a result of the acquisition and a fear of being displaced. Obviously, it is the most marketable of the target company's employees who are successful in finding what they perceive to be more secure positions elsewhere.

Be Realistic About Business Prospects

Most businesses' performance can be improved. Furthermore, an acquisition may be just the tool to create the operational shake-up needed to increase productivity and profitability. An effective acquisition will often weed out a target company's unsatisfactory practices that had been immune to change or were perhaps unnoticed. However, at the end of even a successful turnaround, the buyer will generally end up with a company that does not significantly out-perform the competition.

This issue is of most concern when the acquiror is venturing outside of a known industry or market area — a practice most dangerous in a turnaround setting. Competitive benchmarking, or measuring a target against the performance of a group of competing firms, is a critical step in evaluating expected results from the acquisition.

Don't Forget The Customers

This is fine advice in any acquisition setting. It is critical to the success of an acquisition of a troubled company. Such transactions are often justified by so-called "synergies", that elusive potential which exists when a buyer's or seller's operation provides certain missing ingredients that will unlock the other company's potential. This often includes plant closings or relocations, personnel changes and other changes which may or may not be all that appealing to the target's customers. Such issues require extensive conditioning of long time customers that are accustomed to a certain way of doing business.

A Hasty Deal Is Likely To Be A Bad Deal

"Due Diligence" is a term that makes buyers think of legal and accounting boilerplate items that go along with any buy/sell transaction. Many buyers take a bare bones approach to due diligence because of their relative experience in making acquisition. In troubled situations, even the most sophisticated buyer must do its customary due diligence — and then some.

Although it would be unfair to state that all troubled companies suffer from record keeping deficiencies, it is safe to say that such situations lend themselves to a bit of extra caution when it comes to verifying data provided by the seller. Particularly in troubled situations, there is often found a conflict between what the books say and what is found upon further investigation.

Use The Best Professional Advisors Available To You

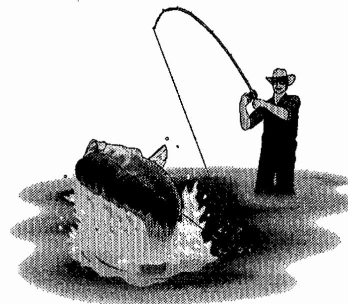
This is important in any transaction and particularly so in a troubled setting. First, the professional advisor will keep the buyers' emotions out of the transaction. Secondly, buying a troubled company requires that many buyers learn an entirely new set of ropes featuring peculiarities unique to troubled company acquisitions.

The role of experienced advisors is especially critical in a troubled setting because of the unique aspects of these transactions. Often, these targets have tried some unusual financing techniques in the past and the buyer must become adept at analyzing a firm with a heavy dose of, let's say interest-deferred debt securities such as PIKs, resets or zero-coupon notes. Other complicated areas such as the proper use of bankruptcy proceedings, tax issues related to retiring a target company's debt or preserving net operating loss deductions, the value or usefulness of a solvency opinion, and accounting issues such as unrecorded liabilities or aggressive asset valuations used in a previous leveraged buyout all require the expertise of an experienced advisor.

Today's troubled company can be tomorrow's buying opportunity. However, picking up one of these diamonds in-the-rough and shaping it into a valuable gem may prove to be illusory if the buyer is unwilling to go the extra step needed to make such as acquisition successful.

—NCR, September 1993

Landing the Big Ones . . . Without Losing Your Bait



By Richard J. Walters

Investing in companies is much like game fishing. Lenders support businesses by loaning money, but require collateral, i.e. first rights on the boat. Equity investors (venture capitalists) are more adventuresome, they go fishing with and as the owners. Their risk is higher, and theoretically so are the rewards. If they don't catch the trophy fish, they hate to lose the bait (investment) as well.

Investment returns are measured as a combination of all investments in the portfolio (successes and failures). An experienced equity investor may look at 100 opportunities for every suitable investment. He undertakes weeks of due diligence on the market, competition, product or service, management team, exit strategy and financial rewards prior to investing. If the potential is acceptable, the investor will fund the growing business with the expectation of returning, say three to five times their original investment over a five year time horizon — always looking for the one in one thousand investment that will return ten or more times their investment. The investor seeks varying degrees of diversity. He will target specific markets which can offer the yield potential, e.g. technology, communications, healthcare, or specialty retail, vary these investments by stage of development and limit the investment in any one company to no more than say, 10% to 15% of total available capital.

Despite all the planning, expertise and due diligence used to select investments, unforeseen and unplanned events will occur. The truly outstanding companies with defined market needs, superior management talent and adequate funding will shine early and proceed with minimal oversight. Likewise, those investments that are poorly conceived and ineffectively executed will also be recognized early and allowed to wither without additional funding. In a portfolio of ten investments there may be one outstanding company and one early loser. The remaining eight require the critical ongoing decisions in terms of dollars invested and time involvement.

The ability to improve the value multiples from performing investments and prevent erosion of capital invested in underperforming ones will determine the difference between fair yield and above average performance. Knowledgeable investors recount how they sensed weaker investments were "in trouble" before the financial statement verification — "it just didn't feel right" or "it didn't pass the gut check." When pushed further, they admit they were slow to take the necessary remedial actions and with the situation unchecked the equity was allowed to deteriorate.

What happens when one is in trouble?

Equity investors look at different criteria to measure failure than other investors. An equity investment is in trouble when the original timing and expectations of returns and liquidity have been substantially modified.

The investor first turns his immediate attention to revalidating the fundamental market, product or service, and business model results. He reconfirms the underlying concept, current customer acceptance, competition and financial value of his original investment decision.

In cases of early diagnosis the board of directors moves decisively to recruit and install new leadership better able to execute the business plan. The value of a permanent management team at the time of exit from the investment, makes this a preferred alternative. In some cases this decision coincides with an additional round of funding.

If the situation is totally disastrous, the investor often inserts himself as CEO (thereby becoming a turnaround manager) to closely control the company's costs, and either prepare it for sale or liquidation to recoup what he can.

More often, the troubled situation is not this clear cut. The fundamental elements are hard to revalidate (and help is needed to do so) or the trouble is poor management, which is not easily replaceable. The tendency for most equity investors is to do it themselves, after all, they rationalize, who knows more about the company, its goals or its situation? This decision is probably driven purely by the return on investment motivation, or that it won't take very long to fix.

Is this decision wise? That depends on your view. Is the best use of a portfolio investor's time to manage the seven remaining companies to their maximum return multiplier, or to dedicate precious time and resources to the troubled investment?

It makes sense to bring in a professional.

Equity investors often come from a finance or investment banking background — are they really qualified to run the company? Probably not. Even if the investor comes from an operating background, and many do, should they run the company? Usually no, they probably haven't done so in a troubled environment before.

Struggling companies need leadership, direction and additional specialized skills and experiences that most successful managers have never been exposed to in their careers. Effective, clear communications with customers, vendors, lenders, employees and shareholders are essential. Available options and decision making are compressed in troubled companies. Cashflow becomes critical. Timely execution and detailed follow-up are critical to immediate survival and a prerequisite to recovery, renewed vitality, and return of the original investment. Can the investment professional afford to devote the necessary time, undivided attention and the day-to-day leadership continuity to rejuvenate and turn the troubled company? Is this the most effective use of his limited time? What about the management of his other growing investments? Should he ignore the potential winners (seven) to save the lone straggler?

There is a more effective approach.

Experience shows that troubled investments with timely outside professional corporate renewal assistance can bring the lone straggler back, return the original investment, pay the fees, often without additional infusion of capital (or minimal). This strategy allows for the straggler to be returned to normal, where the decision can be made to continue or not. If so, you have bought time, time to recruit the "marquee" manager that is required to take the company to original (or acceptable) expectations. If the investor grows tired, the company can be sold, at a much higher value than before the professional was brought in.

Qualified turnaround specialist firms work not only on survival but also provide the mature management and planning bridge back to viability. Like the investment professional they have honed their skills and capabilities.

The economics are compelling. In the final analysis of success it will be how effective the equity investment manager is in exploiting his talents and available resources, from permanent company management to turnaround professionals, that will determine the maximum yield on the portfolio.

When the seven companies provide high multiples the equity investor is happy with his catch. When the lone straggler is revived, and returns at least his original investment, the investor reclaims his bait to be used another day. *—NCR, May 1993*

TMA Members Become "GOOD SAMARITANS"

Pro Bono Help Saves Small Enterprises

By Mike Brose

By day, you might see them in spacious executive suites in a large industrial park or in the corporate boardroom of a gleaming skyscraper. But by night, they're more likely to be found in a cramped office in the warehouse district or in the loft of an inner city dance company. If they're not Bruce Wayne and Dick Grayson by day, alias Batman and Robin at night, then...Who are they?

More likely than not, they're members of the Turnaround Management Association, a national group of professionals who provide consulting services to rescue companies that are in serious financial difficulty. But in their spare time, often in the evening or on weekends, many of these TMA members donate their services to small businesses and non-profit organizations who are struggling to reach their goals — or simply to survive. By volunteering to help other organizations in their community, these TMA members are regarded by many as not just good neighbors, but as "Good Samaritans."

A number of TMA chapters across the country have established formal programs to provide "pro-bono" services to needy organizations. Generally, the chapters work with relatively small organizations, which lack the financial resources to retain the business or managerial expertise that may be needed.

Also, individual TMA members and their firms, even without a formal chapter program, have donated their services, primarily to non-profit organizations. Because members are proven managers with broad backgrounds in marketing, operations, and finance, they can usually identify problems quickly and recommend immediate actions to take.

Assisting Small Business

How to create jobs in a period of massive restructuring and permanent downsizing of businesses has become a critical issue for the U.S. economy. Recognizing that job creation over the past decade has been greatest among small businesses, state and city governments have formed Economic Development agencies to support small business growth. In Connecticut, the TMA chapter initiated a cooperative program with the state's Department of Economic Development (DED) to help small firms. As Dick Wirth of Wirth Ventures and chapter president explains: "CTTMA members are helping Connecticut companies survive during an unparalleled decline in the defense industry. Our members have aided over 75 companies and contributed consulting services valued at more than $500,000."

From the perspective of Connecticut's DED, the program was just what they needed. Listen to Tony Brescia, senior regional manager at DED: "Our concern was how to help companies that needed expertise right away, but couldn't wait for the usual state government process. Governor Weicker encourages entrepreneurial state government, so we set up an informal State/CTTMA collaboration to do what was best for our state's economic development. We just did it!"

Is the CTTMA program working? Gary Bernhardy of Operating Management Associatates and the program's Liaison Director, responds: "Our pro-bono program has achieved very high recognition and, as the word has spread, the State has received calls from banks who want to put their companies into the program."

At the TMA New Jersey chapter, a similar program is underway with the state's Economic Development Department. Bob Seidman of R.N. Seidman & Partners and chapter president, observes: "We provide a list of volunteer TMA member companies and a description of their services to the state, and the companies select the firm to use. Right now, we have 3 cases in progress, all in the middle market size range." And in Boston, TMA chapter president, Gerry Sherman of Boston Financial Advisors, says "We're exploring several avenues including participation in the state's newly formed 'Space Council' that will address economic diversification issues."

Among the other TMA chapters planning to adopt similar programs is New York, where David N. Deutsch of Congress Financial Corporation and Program Chairman, remarks: "Various members' firms are already sharing their turnaround expertise with firms that cannot afford to retain their services. Our chapter is also discussing plans for a more formal program." And in Houston, Ron Diderich of Kenneth Laventhal & Company and chapter president, adds: "We're considering assisting new start-up businesses that are affiliated with university 'business incubators' and we are talking with Texas A&M and Rice officials."

TYPICAL PROGRAMS

TMA Chapter	For Profit (Organizations Served)	Non-Profit (Organizations Served)
Atlanta		IM
Chesapeake		IM
Chicago	CP	CP
Connecticut	CP	CP
Los Angeles/SW		IM
New Jersey	CP	
New York	IM	

CP - Chapter Program, IM - Individual Member

Helping Non-profits

Fallen Angels. Just the words somehow make images of Marlene Dietrich, Jean Harlowe, and Susan Hayward float through your head. Or perhaps Marilyn Monroe if you're a bit younger. In reality, though, "Fallen Angels" is the aptly chosen name of the Chicago chapter's program to help struggling young organizations get on their feet.

Randy Patterson of Turnaround & Crisis Management and Chicago's chapter president, emphasizes that "our purpose in starting the program was to fulfill our members' desire to give something back to the community. While we assist small business primarily, we have also had good success working with many non-profit groups." To date, the Fallen Angels have assisted a community arts center and are currently working with two different inner-city theater groups.

Reaching out into the sprawling and diverse Chicago community posed a challenge to the TMA members. Recalls Bob Tepper a Chicago attorney and Executive Director of the Fallen Angels Assistance Program: "We recognized very early that the Fallen Angels program represented a major marketing challenge. How do we identify the organizations to serve? Are there 'referral sources' beyond our membership, such as public or private agencies, that we need to reach?"

Chicago's answer to the problem was to begin contacting various city government agencies concerned with attracting and maintaining businesses and with supporting the myriad arts and community groups. Discussions with the Mayor's Office led to the Business Development Center which contained divisions for Business Services, Neighborhood Services, Industrial Development, and Planning. Another referral source has been the Chicago Enterprise Center, a city-sponsored agency that matches organizations with resource groups that can provide assistance. The Center's Holly Trueblood enthuses: "We've worked with the Fallen Angels volunteers on a half-dozen projects and found their capabilities to be of the highest caliber. We appreciate their ability to do what is best for the client and they've been simply wonderful to work with."

Running the Fallen Angels program requires persistence and dedication by the members, says Scott Saslow of Buccino & Associates and Director of Member Services. He maintains "Once a chapter starts a program like this, they really need to stick with it because it might take 6-8 months to get everything in place and running smoothly. To keep pace with the program's growth, we hope to involve more members in liaison activity with the referral agencies. And, of course, we'll need more volunteers to handle the projects." *(Continued on next page)*

"Avoidum Verbositae Redundae"

Hazards to Avoid When Your Asset is Real Estate

By Joe Foster

Time and money can be saved by obtaining the exact type of appraisal which serves your client's needs rather than to order the standard appraisal from a Member of the Appraisal Institute (MAI), a lengthy compendium containing a great deal of information which may be irrelevant for your needs. Listed below are four types of evaluation formats which can be considered:

Letter Opinion of Value

Quite often management has an accurate idea of the value of its real estate but just wants a confirmation or second opinion from a knowledgeable outside source. This approach can be especially effective on simple properties such as land, warehouses or commercial buildings. For example, it does not take a rocket scientist to accurately estimate the value of a dock high, 20,000 square feet standard warehouse with 5%-10% office space in an established industrial district. Rather, an experienced industrial broker active in the area can probably respond within 60 seconds after he has familiarized himself with the building, and can easily provide a two or three page letter summarizing its physical characteristics, location, estimated market rent, and brief but accurate economic and/or market data-based valuation.

Do not expect an MAI or even a state certified appraiser to prepare this letter opinion, because the new appraisal rules, as discussed below, require literally dozens of pages of boilerplate. Instead, you can usually turn to an experienced real estate practitioner. For practical purposes, members of the Society of Industrial and Office Realtors (SIOR) or American Society of Real Estate Counselors (ASREC) be used because they have, by membership in these organizations, demonstrated a substantial amount of expertise and experience.

Short Form Evaluation

If the property is more complicated but the credibility of a designated appraiser is still not necessary, a 5-8 page report plus limited exhibits (such as floor plan, site plan, pictures and location map) should be more than sufficient. These short form reports can be expanded to include additional aspects which may be of special importance (such as expansion feasibility on adjoining excess land or estimated rehabilitation costs). It can be just as accurate as the full blown version, much easier to read, and much less expensive. It will most probably include both the income and market data approaches, but will probably exclude the cost approach, which is superfluous in the great majority of appraisals, since existing real estate is rarely bought on the basis of the cost approach.

Once again, you will probably need to turn to a non-MAI, but he or she may be selected from the ranks of the ASREC, whose members hold the Counselor of Real Estate (CRE) designation or from other groups such as SIOR.

At this point you need to know that several appraisal groups, including the MAI's, recently formed Appraisal Foundation, a self-policing entity. The foundation has issued the Uniform Standards of Professional Appraisal Practice (USPAP) which governs the items required in and format of an appraisal prepared by its members, and permits the following 2 basic types of reports:

Limited Report

The thickness of this report is generally midway between the short form evaluation and the full appraisal report, except that a number of items must be addressed which may be of little or no interest to your client, especially if he is already familiar with the property and the report is being used for internal purposes. However, it permits the signature of an MAI and will carry more credibility if needed in testimony or submission to lenders. It will also probably cost half again as much as the short form evaluation.

Full Appraisal

If you know that testimony is inevitable or you must have a report for the RTC, FDIC or a financial institution supervised by one of the above, this is the way you will probably have to go. It is simply an expanded version of the limited report, may well be the size of the telephone book of a small city, will probably have 10-20 comparables when 3-5 would otherwise suffice, and may include irrelevant information such as freight car loadings for the last 10 years. It will also include the cost approach to value unless you request otherwise. It will probably cost twice as much as the short form report and half again as much as the limited report, but it will have the highest level of credibility (at least as to format). Anyone spending this kind of money should require that it be authored by an MAI.

SUGGESTION: Select the least expensive format which will serve your specific needs, especially if there are several properties which need to be evaluated. There are many qualified real estate practitioners who can provide your client with just as accurate an estimate of value as designated appraisers.

—NCR, July 1993

TMA Good Samaritans *(Continued)*

Additionally, the non-profits served by individual TMA members and their firms cover a wide range of activities. For example, Atlanta chapter president, Bob Starzyk of Arthur Andersen & Company and Los Angeles/Southwest president, Randall Eisenberg of Price Waterhouse, report that their members have been involved with such diverse groups as a community college and an inner-city theater company. At the Chesapeake chapter, Linda Christie of Strategic Management Partners in Annapolis, Maryland, consults with a foundation for the severely disabled to bring advanced technologies to enhance the patients' lives.

Why Do It?

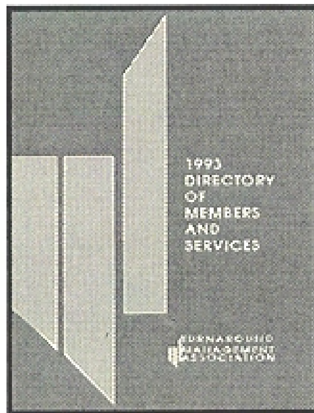
Clearly, the satisfaction of helping others is the primary motive, as well as the reward, for TMA members involved in Good Samaritan programs. But there appear to be other indirect benefits as well. In Chicago, for example, Crain's Business and the Chicago Tribune have featured articles about TMA's work, thus enhancing the professional reputation of TMA and the members involved. And, several chapters have found that awareness of the members' pro-bono activities has led to referrals to other fee-paid work. Overall, TMA's Good Samaritan activities prove the old adage, "when you help someone up a hill, you are a little nearer the top yourself."

—NCR, September 1993

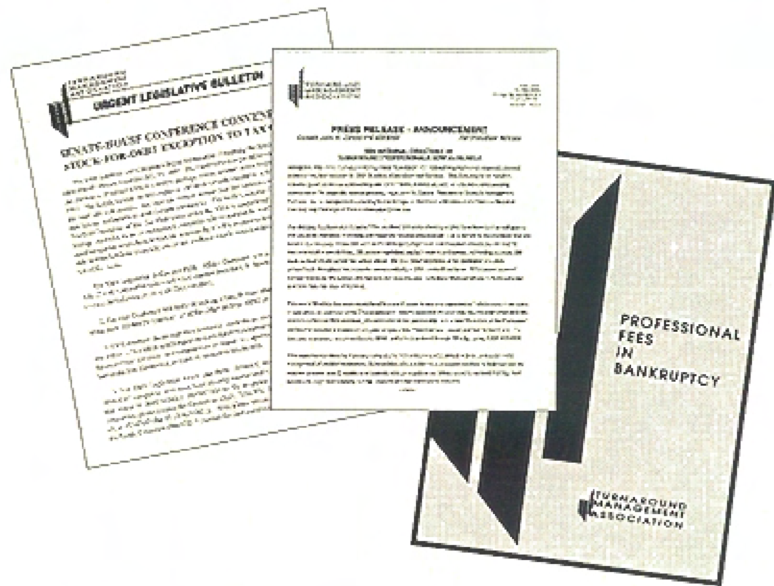
TMA PUBLICATIONS

Newsletter

Directory



Periodic Publications, Press Releases, Legislative Alerts



Special Events