

BANKRUPTCY & CORPORATE RESTRUCTURING

Closely held company issues

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All companies have problems coping with the onset of economic difficulty. Coping with the transition from a stable healthy environment with ample financing to one in which suppliers, lenders, employees and shareholders perceive the entity to be at least challenged, if not on the verge of outright collapse, imposes huge stress on all managements. Denial, paralysis, anger, frustration are the emotional mindset of management in all companies approaching the zone of insolvency or entering bankruptcy. Whether or not the cause of a company's troubles is directly related to management's inadequacies or to unexpected and novel external forces, management typically resists outside assistance at the onset of serious corporate trouble as they view the company's financial difficulty as a personal reflection on themselves.

These factors are magnified in closely held companies because the founder(s) or the founding family frequently dominates management and their self esteem is intimately tied to the company's performance. In addition, the economic health and viability of the company has a direct effect, not just on their own salaries and personal prospects but on the net worth of their family. They often have to answer to relatives who don't work in the company but count on its viability to produce the dividends which make their lives comfortable. In troubled times, these factors significantly add to the burden of management in closely held companies.

Conflicts which are present for all companies approaching the zone of insolvency are more starkly obvious in closely held companies because of the overwhelming focus in such companies on providing value to shareholders bound to the management by family ties. While all management has to cope with the shift of fiduciary duty from shareholders to creditors, in closely held companies this shift creates extra stress as management and boards of directors, frequently dominated by family and friends, who have to come to terms with the fact that what they have always thought of as their property is no longer exclusively available to satisfy their needs and that of their families and friends who are shareholders.

Explaining this shift in fiduciary duty to passive family shareholders is excruciatingly difficult. This situation creates a corporate governance

nightmare in which independent management and board decisions are often compromised by personal need and family pressure. Long after it is appropriate to do so, decisions continue to be made with a view to enhancing or preserving insider shareholder value while ignoring or minimising execution risk which puts the company's creditors at increasing risk.

Where the closely held company is also public these stresses are compounded by the requirements placed on management to deal with regulators for public shareholders whose interests are different from those of insiders as well as with creditors to whom management now owes a direct fiduciary duty that did not exist when the company was healthy.

In most businesses, the board of directors is a source of reason, once its members understand the realities a troubled business faces. However, in closely held companies, even 'independent' directors are often not truly independent. Frequently, they are friends or cronies of the founder or the founding family and unwilling to risk their personal relationships until it is too late to save the company and protect creditors. Alternatively, family or founder control can lead to situations where a board that wishes to act appropriately is summarily dismissed by the controlling shareholder(s). While the personal consequences of such actions may eventually be dire for the controlling shareholders, particularly in a public company subject to regulatory scrutiny, by the time these decisions are subjected to regulatory scrutiny the damage to a company's chance for survival has long passed. Even if insiders are eventually punished for failing to carry out their fiduciary duties, the chance for a recovery for creditors is long gone and any retribution provides little or no compensation to those damaged.

Restructuring a closely held private or public company is also made more difficult because of unique management characteristics in such businesses which make achieving focus on and buy in for change more difficult.

Generally the Chairman and Chief Executive Officer of closely held companies is the founder/patriarch of the company and family. If not by the founder, these positions are frequently held by second and third generation descendants of the founder(s). In this situation, personal ►

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identification with the business and/or family ties and responsibilities often impede clear thinking about changes needed in the business when trouble arrives. Trying to persuade a founder who has built the company or a family member who has inherited their position that they have to relinquish control to save their business is often completely impossible. Indeed, many businesses are sold off or liquidated because the founder or family cannot accept reality and blocks more effective alternatives. In these situations lien holders are generally protected but unsecured creditors are at risk for total loss.

Decision making in closely held companies is therefore often driven by emotional considerations and personality rather than facts, risk identification and assessment. The fact that so much of a closely held company's management net worth is tied up in ownership of the company influences the decision process in good times and bad. In good times this is at best irrelevant and at worst a minor annoyance. However, in bad times it can cloud rational thought and prevent independent thinking

which does not focus on preserving owner value. Owners of closely held companies who have not or could diversify their personal wealth beyond the company are particularly susceptible to this trap. Even the act of monetising a company's net worth through a public offering is only the first step in diversifying a family's holdings and lowering the founder(s) or family's dependence on the company's performance. Oddly, even when a family has diversified, unless they also bring in professional management, family members running a company still identify their personal view of themselves with the company's performance and are unable divorce their control from the needs of the business and make the difficult decisions in tough times. Part of this stems from a reluctance to give up control and often leads to poor compliance practices and to governance which focus more on the needs of the family owners than on the needs of the company. Planning in such companies is usually more ad hoc than in professionally managed companies and, at least on the founder's watch, there is a greater willingness to 'bet the farm' and the creditors' security on an emotionally made decision than in professional managed companies.

Why are these concerns particularly relevant to practitioners in the corporate restructuring world? Because most companies are in fact closely held and/or family dominated. While mega companies like General Motors, Microsoft or IBM in the United States have moved beyond their family roots and employ professional management to make their critical decisions, in the middle market that is less true and among smaller companies professional management not dominated by founder or family control is virtually non-existent. Indeed, in some parts of the world even the biggest companies continue to be closely held and family dominated. As a result, understanding the dynamics which drive closely held company governance and independent decision making is critical to turnaround managers and attorneys who need to work effectively with clients who are faced with making critical decisions to preserve value in their organisations as they try to restructure the companies that hire them. ■

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