'Informal' Engagement Agreements Are History

Reasonable precautions may prove invaluable

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In a country in which litigation, not baseball, has become the real national pastime, turnaround professionals should be concerned about their potential exposure to lawsuits, regardless of their actual liability.

Nearly every turnaround management engagement begins with an engagement agreement. Historically, turnaround professionals used an informal and relatively simple "engagement letter" that required a client's countersignature.

That came to an abrupt end with the *Merry-Go-Round* case[1], which was akin to "Three Mile Island" for the turnaround profession. Ernst & Young, which acted as pre-petition and post-petition advisors to the debtor, paid $185 million to settle allegations that it committed fraud and acted improperly in the advice it gave in the clothing retailer's reorganization. While there were aspects to *Merry-Go-Round* that may appear to have been avoidable, such as the allegation concerning the disinterestedness requirements of section 327 of the U.S. Bankruptcy Code, other assertions concerning the quality of services provided, invoicing, and staffing are more troubling.

In a country in which litigation, not baseball, has become the real national pastime, turnaround professionals should be concerned about their potential exposure to lawsuits, regardless of their actual liability. It is often said that the U.S. judicial system doesn't determine right and wrong, just winners and losers, and so the truest lesson of *Merry-Go-Round* may be, "forewarned is forearmed."

Even in the absence of the harsh lessons of *Merry-Go-Round*, dealing with distressed businesses is a bruising process, and it is rare that all parties in a case are satisfied with the result. Indeed, some bankruptcy judges say that the universal frowns that often greet their rulings are an indication of a fair compromise. In such an arena, taking reasonable precautions at the beginning of an engagement might prove invaluable later, when parties dissatisfied with the result look for someone to blame.

For these and other reasons, turnaround professionals increasingly are using more formal engagement agreements. This article examines such engagement agreements and highlights some of the issues with which turnaround professionals should be concerned in fashioning their agreements with clients.[2]

At the outset, a distinction should be made between bankruptcy and non-bankruptcy engagements. While non-bankruptcy client engagements are governed primarily by state contracts law and — for TMA members — the TMA Code of Ethics, employment in bankruptcy is governed by section 327 of the Bankruptcy Code.[3]

While a turnaround professional's non-bankruptcy engagement agreement may be attached to the application for employment in bankruptcy, its terms are "trumped" by the Bankruptcy Code. The U.S. Trustee and others may object to an application that contains limitations of liability, indemnification, or other provisions that are inconsistent with local precedents.

In bankruptcy engagements, turnaround professionals often retain their own local counsel in connection with their employment applications. Legal issues of limitation of liability and indemnification for turn-

around professionals, in addition to how disinterestedness relates to pre-petition and post-petition roles, are still unsettled in many areas of the country. Disparate rulings across judicial circuits may make hiring one's own counsel a necessity.

Because bankruptcy engagements involve special considerations, this article focuses on engagement agreements only in non-bankruptcy situations. However, bankruptcy and bankruptcy alternatives, such as state receiverships and assignments for the benefit of creditors, are backdrops for most turnaround situations. All parties — debtors, lenders, and trade creditors — are continually measuring the relative attractiveness of bankruptcy as an alternative. So even non-bankruptcy agreements should be formulated with the knowledge that bankruptcy may become a reality at some point during the engagement.

TMA's Code of Ethics does not mention engagement agreements. The author recommends that TMA consider whether the code should be amended to require a written and mutually executed engagement agreement that contains the basic contractual elements discussed in this article.

Essentials of an Agreement

Engagement agreements should address the following issues:

- Parties to the agreement
- Recitals
- Term of the agreement
- Services to be rendered
- Staffing
- Fees and expenses
- Reporting responsibility, confidentiality, and access
- Representations and warranties
- Indemnification

• ***Parties to the Agreement.*** "Who is the client?" is not a rhetorical question. In every client situation there are multiple stakeholders: shareholders, directors, officers, employees, lenders, creditors, and the outside community. In particular, conflicts of interest can arise between parties in a closely held corporation and in scenarios involving personal loan guaranties. For example, a business owner-operator might want to give preferential treatment in paying down debts that he has guaranteed over those that are not guaranteed, or he may favor holding on to cash, regardless of what would be best for the business.

A business, whether a corporation, a limited liability company (LLC), or a partnership, is a creature of state law. Corporations and LLCs are *persona ficta,* having many of the rights of natural persons, such as the rights to own property, conduct business, sue and be sued, and pay taxes.

Maintaining a separate corporate existence, and the limited liability of shareholders that it affords, requires proper attention to "corporate housekeeping," including shareholders' meetings, the election of directors, and the appointment of officers. Failing to do so can result in "piercing the corporate veil" and result in personal liability. State corporation laws typically recite that "the affairs of the corporation shall be managed by the board of directors." In these post-Enron days, corporate governance is more than a buzzword, and turnaround professionals should take it seriously.

It is therefore critical that an engagement agreement accurately specify a turnaround professional's client, which is typically an incorporated business. There may be similarly named affiliates, subsidiaries, or parent companies whose interests may be different from the client's, and these distinctions must be observed in the agreement.

In the case of a retail chain for which each store may be a separate corporation to prevent automatic cross-exposure to lease liability, it may be important that the turnaround professional be engaged by the parent corporation and not by one of the troubled subsidiaries. It also helps to have named the client accurately in the engagement agreement if it should become necessary to enforce any of the document's provisions. When in doubt, a turnaround professional should seek advice from his or her own counsel, not from a client's attorney.

Finally, is the turnaround practitioner executing the agreement as a firm or as an individual? Even if staffing commitments are made that include providing specific individuals as interim officers or case team leaders, the entity with whom the client is contracting must be made clear in the engagement agreement.

• ***Recitals.*** These "whereases" can be helpful should it become necessary to interpret the engagement agreement. For example, a recital that the client is insolvent at the outset of the engagement (assuming that's true) could be helpful if it were ever alleged that actions by the turnaround professional had damaged the client's value. Such a recital could also make it easier for a turnaround professional to help officers and directors recognize their fiduciary duty to creditors, if appropriate.

At a minimum, recitals should evidence that the client desires to engage the turnaround professional to provide the services described in the engagement agreement, that the turnaround professional desires to provide such services, and that both parties intend to be bound legally by the engagement agreement. It is also helpful if the first line of the engagement agreement states that the document is an "agreement."

• ***Term.*** Every contract should have a term and should either specify when it expires automatically or renews for another term if not terminated by a party. The engagement agreement should specify when and how either party can terminate the agreement and what happens to any work then in progress. A notice provision should be included, and the turnaround firm should make it — clear that it has the right to resign immediately if the client engages in illegal or unethical behavior.

• ***Services.*** The "scope of work" is perhaps the most important part of the engagement agreement. It should describe in detail — sufficient to prevent any misunderstandings — what services are to be provided and in what sequence and manner. Central to the scope of work is the role in which the turnaround professional will serve: is the practitioner an "advisor" or a "manager?" This is critical, and the specification of an advisory role should go on to state that the client's directors and officers remain responsible for all decisions concerning the client's business.

Likewise, when a turnaround professional serves in a management role, the exact breadth of his authority should be specified. A written resolution of the company's board of directors may be necessary to authorize a management role, and in such cases the turnaround professional should make it an attachment to the agreement.

Turnaround professionals serving in management roles should recognize the legal liabilities they take on. For example, taxing authorities may hold a manager personally liable if the client is deficient in its payments, and environmental regulators often look for individuals, not just companies, to hold responsible for violations.

Finally, the Bankruptcy Code explicitly considers a debtor's officers and directors not "disinterested" for post-petition employment as a professional. As a result, pre-petition engagement as an interim officer can cause complications for services to continue post-petition.

If specific deliverables are promised, the timetable and form in which they are due should be set forth. For example, a report can be oral or written, and a written report can be presented in bullet-point format or in a long document. The agreement should also specify whether multiple presentations are to be made — to the board of directors, the lender, or others.

If financial projections are to be prepared, the agreement should specify who is to prepare them. It is quite common for clients to overestimate the capabilities of their own financial staff, so the scope of work and the fee budget should state explicitly any applicable assumptions about who will do what.

Many professionals describe the scope of work in phases, particularly with respect to the fee budget, because it may be possible to estimate costs only through the first milestone. For example, the first phase might include formulating projections, determining and choosing among strategic alternatives, presenting a proposal to a lender, and negotiating terms of a forbearance or restructuring.

Subsequent phases, the costs of which may be difficult to estimate at the outset of the engagement, might include implementing necessary corrective actions identified in the first phase, monitoring and reporting a client's performance in accordance with a revised business plan and budget, preparing for the sale of all or part of the business or for a bankruptcy proceeding, or providing interim management.

If an engagement might go in different directions based on the outcome of the early phases of work, then such contingency serv-

ices should be spelled out. This is true even though in a bankruptcy, for example, a formal employment application and court approval would be required.

The scope of work should be revisited periodically and modified in writing whenever appropriate, such as when services not originally included in the agreement are requested or when a client is unable to provide in-house assistance that it promised. It is quite typical for a client to be initially willing to contract for a narrower description of services than it will eventually require; the key is to confirm the changes in writing.

• ***Staffing.*** In many cases a client requires a representation as to who will provide the services. This is especially true in engagements involving management services; the client understandably wants to approve who will be chief restructuring officer, for example. Indeed, if board authorization is necessary under applicable state law, a board may be required to appoint an individual rather than a firm to an officer's position.

It is to the turnaround professional's advantage that commitments regarding staffing be included in the written engagement agreement. It is axiomatic that all understandings the client may have about the turnaround engagement should be written into the agreement. It is advantageous to have a written record that the client has been advised as to who will perform services.

Because it is implicit in the staffing decisions made by a turnaround professional that everyone on the engagement case team is qualified for the tasks assigned to them (and also required by Ethical Standard 2.3 of the TMA Code of Ethics), why not document these decisions? If staffing substitutions or additions are made during the engagement, these should be treated as any other change and documented through a modification to the written agreement.

• ***Fees and Expenses.*** This is an area that can easily breed misunderstandings with a client. Many clients are resistant to change and may have opposed the engagement of the turnaround professional from the outset. While the central issue may be autonomy and a preference to "fix the problem themselves," a client's recalcitrance frequently fixates on the turnaround professional's cost as a pretext. Therefore, it is advisable to leave as little chance for misunderstanding as possible. Billing rates should be clearly set forth, including whether and how these may change. Applicability of hourly, per diem, and weekly rates should be specified, as should whether travel time is to be charged and in what instances. If a fee budget, range, or cap is included, the scope of work and the underlying assumptions on which these are based should be stated clearly. If a turnaround professional determines that the scope has changed or variation from the assumptions has occurred, the client should be notified at once in writing.

Success fees can be problematical. It may be difficult to determine whether the conditions for payment of the fee have been met. For publicly held companies the stock price can afford a ready reference. Closely held companies may be trying to "break even higher and higher every year" and for these companies, financial yardsticks such as earnings before interest, tax, depreciation, and amortization (EBITDA) improvement can be elusive. Transactional events, such as avoiding bankruptcy for a specified period, confirming a plan of reorganization, or closing on a sale or refinancing, may be more helpful.

In any case, the engagement agreement should clearly state the conditions on which success fees depend and, in the case of transactions, whether the turnaround professional's contribution (finding the buyer or the refinancing source, for example) is a required condition.

Reimbursable expenses should also be delineated in the engagement agreement. It might be helpful to include in the agreement what class of travel and lodging will be reimbursed and whether receipt copies will be required. Some clients require that out-of-town travel be approved in advance.

Payment terms should be clearly written and followed because distressed companies make poor credit risks. Recent bankruptcy court decisions have also put professionals at risk for preference avoidance if they allow the client to get behind in payments. Similarly, how retainers are to be paid and applied should be included in the engagement agreement.

• ***Reporting Responsibility, Confidentiality and Access.*** A corporation is managed by a board of directors that appoints management. Optimally, a turnaround professional should report to the board of directors, even if daily contact is with the CEO or CFO as the board's designee. At the very least, a turnaround professional should know who is on the board and how to contact them.

TMA's Code of Ethics requires that a client's confidential information not be disclosed. Many clients require turnaround professionals to sign nondisclosure agreements, and engagement agreements often contain confidentiality provisions as well.

These provisions might inform the client that communications with the turnaround professional are not legally privileged. They may also specify whether the practitioner is required to notify the client if the professional is subpoenaed or may otherwise be required by law to make disclosures of confidential information. That may give the client an opportunity to seek a protective order covering trade secrets and other proprietary information.

Having direct access to lenders and creditors can help restore credibility and build support for the turnaround plan. Turnaround professionals frequently need untrammeled access to parties outside a client's organization to be effective, and authorization for the turnaround professional to have such access should be delineated in the engagement agreement.

• ***Representations and Warranties.*** It is sometimes said that success as a service professional lies in managing a client's expectations. So it is important that the turnaround professional be explicit about what results, if any, are promised. Better yet, he or she should specify that distressed business situations are risky, and therefore no specific results are promised.

The *Merry-Go-Round* case raised the issue of the standard of performance applicable to turnaround professionals. Therefore, it is advisable to specify a standard in the engagement agreement — best efforts, reasonable efforts, and ordinary business judgment are all examples of standards that might be used — so that none need be imputed. Certification by the Association of Certified Turnaround Professionals1s (ACTP) is a meaningful and valuable asset for the turnaround professional, but it should not create inferentially a different standard of performance. Many turnaround professionals are also CPAs or attorneys, and it is important to recite that the turnaround engagement does not include services for which a license is required.

It is also advisable for the client to recite that it is current in its tax payments, especially trust fund taxes, and that it is in compliance with such regulations as health and the environment. These are areas that could entangle a turnaround professional, especially when he or she is acting in a management role.

• ***Indemnification.*** Following from the standards of performance is the liability to which the turnaround professional may be exposed. Turnarounds seldom produce smiles all around, and litigants have been known to cast a wide net. The turnaround professional can cogently argue that he or she should be free from concern about personal liability to concentrate on the client's problems.

While many engagement agreements carve out illegality and willful misconduct, indemnification of the turnaround professional by the client is appropriate and has recently found increasing favor among bankruptcy courts.

Some indemnification clauses also exclude gross negligence, although the line between gross negligence and simple negligence is difficult to discern. Of course, indemnification by a company that is financially challenged is of limited value against third-party claimants and could be an avoidable executory pre-petition contract by a client who subsequently files bankruptcy. But like chicken soup, it couldn't hurt. Many engagement agreements also include clauses limiting liability to the fees paid to the turnaround professional.

Further Study

Many agreements for turnaround services include other contractual trappings, such as provisions covering choice of law and/or forum, severability, and limitations on assignment and on waivers implied by nonenforcement, just to name a few. The engagement agreement also provides an opportunity to restrict the client from hiring the turnaround professional's staff and to disclose any relationships the turnaround professional has that might otherwise be seen as potential conflicts.

The author reiterates the hope that TMA's focus will continue to cover aspects of firm management and the practice of turnaround management, and that engagement agreements in particular will be a topic for further study and discussion. CR

[1] The author was engaged as an expert in *Merry-Go-Round* but never testified because the case was settled before trial. The court ordered that only information that had previously been made public may be discussed.

[2] The opinions in this article are those of the author and do not constitute the official policy of the Turnaround Management Association or the author's firm. Although the author is a licensed attorney, the positions stated in the article should not be construed as legal advice.

[3] The employment of turnaround professionals as salaried individual employees of the debtor may he governed by section 365 of the Bankruptcy Code: this is discussed in an article by Kurt Gwynne that begins on page 22 of the July 2003 edition of *The Journal of Corporate Renewal*

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