

VIEWPOINT

A Letter And A Handshake: Risky Business For Turnaround Professionals

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One of a series of opinion columns by bankruptcy industry participants.

Dealing with distressed businesses is a bruising process, and it's 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, turnaround professionals should be more aware of their potential exposure to lawsuits, regardless of their actual liability. Taking reasonable precautions at the beginning of an engagement could prove invaluable later, when parties dissatisfied with the result look for someone to blame.

Historically, nearly every turnaround management engagement began with a handshake and an informal "engagement letter" with a client's countersignature. However, engagement agreements have become more formal and lengthy over time. Those that are clear and comprehensive serve as good instruments for managing expectations of clients and other parties.

Nonbankruptcy client engagements are governed primarily by state contracts law, and turnaround professionals aren't licensed professionals like attorneys and CPAs. Except for the Merry-Go-Round case¹, which was never adjudicated and has mainly in terrorem value, a body of case law has not arisen that deals with standards of performance for turnaround professionals. Members of the Turnaround Management Association, or TMA, and in particular Certified Turnaround Professionals, or CTPs, are subject to TMA's Code of Ethics², which includes provisions concerning independence, confidentiality and competence. Adherence to that Code, however, may only be relevant for continued membership in TMA and maintaining the CTP credential. Employment of turnaround professionals in bankruptcy is governed by the Bankruptcy Code and Rules.

Even in engagements that begin as nonbankruptcy situations, the possibility of bankruptcy may be very real, and so the engagement agreement should contemplate that contingency. For example, if the turnaround professional becomes Chief Restructuring Officer, she may be considered "not disinterested" under §327 of the Bankruptcy Code and Rule 1024 of the Bankruptcy Rules because she is an "officer."

Although the various parts of an engagement agreement cannot be fully covered in this article, it should include the following basics:

Parties to the agreement: The engagement agreement should clearly state who is the client, because there may be multiple stakeholders. Although turnaround professionals don't "represent" their clients in the advocacy sense, it is important to delineate to whom the turnaround professional owes his obligations. The interests of the corporate client may not be identical to those of individual shareholders or guarantors, and companies in the "zone of insolvency" may have to take creditors' interests into account.

Recitals: Recitals should declare 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.

Term: The engagement agreement should have a term when it will either expire automatically or renew if not previously terminated. The term provision should state when either party can terminate the agreement, what happens to work in progress, how notice of termination should be made, and whether any provisions, such as fees, success bonuses, confidentiality or indemnification, survive termination. Even if advance notice is required for termination, the turnaround professional should have the right to resign immediately in the event of reasonable suspicion of unreported illegal or unethical behavior.

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(1) *Re Merry-Go-Round Enterprises, Inc.* (D. Md., 94-50161, ESD). Ernst & Young paid a large settlement (not necessarily related to its engagement agreement). N.B. The author was engaged as an expert in Merry-Go-Round but never testified because the case was settled before trial. By order of the court in that case, only information that has previously been made public may be discussed herein. (2) <http://www.turnaround.org/about/ethics.asp>

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Services: The "Scope of Work" should describe what services are to be provided and in what role the turnaround professional is to serve. If the role is advisory, the agreement might state that the client's directors and officers remain responsible for all decisions concerning the client's business. For a management role, the breadth of authority should be specified and should be clear about exercising authority that could involve personal liability, such as trust fund taxes. Any deliverables and timetables should be specified.

Staffing: Any commitments about staffing should be included. Staffing changes made during the engagement should be treated as any other change and documented in writing.

Fees and expenses: Billing rates should be clearly set forth, including whether and how these are subject to change, applicability of daily or weekly caps, whether travel time is to be charged and the underlying assumptions, such as level of assistance from client's management team. Reimbursable expenses should also be delineated.

Success fees can be problematic because of the difficulty in determining whether the conditions for payment of the fee have been met. The engagement agreement should be clear about these conditions, and in the case of transactions, it should specify whether the turnaround professional's contribution, such as finding the buyer or the refinancing source, is a required condition.

Reporting responsibility, confidentiality and access: The turnaround professional should optimally report to the board of directors, even if daily contact is with the CEO or CFO as the board's designee. Minimally, the turnaround professional should know who is on the board and how to contact board members.

Ethical Standard 2.5 of the TMA 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.

Authorization for the turnaround professional to have direct access to lenders and creditors, which helps build support for the turnaround plan, should be delineated.

Representations and warranties: It is important that the turnaround professional be explicit about what results, if any, are promised, or rather, that distressed business situations are risky, and therefore no specific results are promised. It is advisable to specify a standard of performance in the engagement agreement, so that none need be imputed later by a tribunal. Best efforts, reasonable efforts and ordinary business judgment are all examples of standards that might be specified. The turnaround professional's CTP credential is meaningful for the turnaround professional and the client, but it should not substitute for a contractually explicit standard of performance.

Indemnification: Turnaround activity seldom produces smiles all around, and litigants have been known to cast a wide net. Although many engagement agreements carve out illegality and willful misconduct, broad indemnification of the turnaround professional by the client is appropriate and has found increasing favor among bankruptcy courts.

As stated earlier, the foregoing are just the main essentials for engagement agreements. Many agreements for turnaround services include other contractual trappings. For example, the engagement agreement might restrict the client from hiring the turnaround professional's staff and might require disclosure of any relationships the turnaround professional has that might be a conflict in the nonlegal sense.

"A verbal contract isn't worth the paper it's written on."³ A clear and comprehensive engagement agreement is the ounce of prevention that's worth a pound of cure.

(Opinions expressed are those of the author or authors, not of Dow Jones Newsletters.)

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(3) Samuel Goldwyn, *Goldwyn's Law of Contracts*