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Deconstructing the Code

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The original title for this article was “Ethical Issues in Turnaround Engagements.” The plan was to interview a few leading “corporate renewal” professionals and to compile a list of issues uncovered during the discussions coupled with guidance on each topic. The initial interviews, however, not only uncovered dramatic disagreements about what is ethical and what is not but also revealed contradictions and omissions in TMA’s Code of Ethics. Consequently, the scope of the article was expanded to include detailed interviews with fourteen professionals from leading academic institutions, turnaround firms, law firms, and commercial and investment banks.

With regard to the ethical issues in dispute, although most of those interviewed generally agreed on overarching concepts relating to duties to clients and other stakeholders, they held radically divergent views about incentive compensation. The two most controversial topics were percent of the sale of an entity as a basis for compensation (i.e., the percent of sale “success fee”) and turnaround firms whose principals also provide capital to and/or acquire distressed companies through “separate” entities.

TMA, as the leading association dedicated to corporate renewal, has an opportunity and an obligation to examine these issues in the context of an evolving restructuring market. Given that TMA is filled with exceptionally bright, strong-minded members, such discussions will undoubtedly be spirited, and the author hopes that this article will serve as a constructive and informed starting point for TMA's assessment and possible revision of the TMA Code of Ethics.

Key Disagreements among Industry Leaders

Percent of sale “success fee”

The Code: TMA actually has two codes of ethics, one for TMA members and one for Certified Turnaround Professionals, and the codes are almost identical. Both codes say, “A member may accept a performance bonus or other contingency fee” but provide no examples of which types of bonus or fee are acceptable and which types are not. An example of one type of contingency fee is a percent of any sale of the entity, but interviews with experts clearly reveal significant differences of opinion about this mode of compensation.

The viewpoints: Jack Butler, partner at Skadden’s corporate restructuring and governance practice; Joe VanLeuven, partner at Davis Wright Tremaine; and Steve Barkley, former Senior Vice President/Northwest Regional Manager of Key Bank’s Asset Recovery Group, all agreed that earning a percent of the sale of the company is ethical as long as it is fully disclosed and understood at engagement inception.

Al Smith, head of Perkins Coie’s Restructuring Group; Mark Shapiro, Managing Director, Head of the Restructuring and Finance Group, Barclays Capital; and Wim A. Van der Stede, CIMA Professor of Accounting and Financial Management at the London School of Economics, all opined that a percent of sale can be acceptable if appropriately structured. For example, Smith and Shapiro indicated that such compensation needs to be structured so that the financial reward is approximately equal whether the company is turned or sold. “Otherwise,” Smith said, “the professional’s judgment could easily be skewed in a way that is not in the client’s best interest.”

Van der Stede, who made it clear that he is not an expert on restructuring, observed that a contingent fee of a percent of sale makes sense only if it is clear at engagement inception that the objective is to sell the company. He added that the incentive can be “fine-tuned” by incorporating a “threshold selling price” below which the consultant does not receive the commission-type variable remuneration. “Setting such a threshold price helps to ensure that the consultant receives compensation only for good or acceptable performance and not for poor or mediocre performance such as selling the company on the cheap.”

In stark contrast to those who approve, Marty McKinley, President, Fordham Capital Partners, was outspoken in his opposition to a percent of sale being part of a turnaround expert’s compensation. “As CEO of Wells Fargo Business Credit for 20 years, there were two things I would not tolerate from turnaround professionals on our referral list: taking an equity position and acting as an investment banker for the client. Both present clear ethical conflicts....”

“The first priority of a turnaround professional should be to resuscitate the company. Too often, we found that when professionals could earn a percent of the sale of the company, the company ended up being sold—quickly. After all, the practitioner could make money faster by selling the company. As a result, if we thought the company should be turned, we recommended a turnaround consultant. If we thought a customer needed to be sold, we recommended an investment banker.”

Practitioners Tom Allison, CTP, Senior Managing Director, Mesriow Financial Consulting, and David Finkbiner, CTP, a 2006 TMA Turnaround of the Year Award winner, both concurred with McKinley. Finkbiner elaborated, “People in the profession are moving clients and referral sources to sales or liquidations because they don’t know how to turn the company and/or can make quick money when a percent of sale is part of their compensation package.”

Turnaround practitioners “wearing multiple hats”

With regard to the second ethical issue, respondents were asked, “Is it ethical for the principals of a firm that provides the entire spectrum of “restructuring work” to have a separate fund that provides capital and/or buys troubled clients? If so, under what circumstances? If not, why not?”

The Code: TMA’s Code of Ethics is inconsistent in its approach and does not address this specific situation directly. It says, “A member should exercise unprejudiced and unbiased judgment on the client’s behalf...A member shall avoid conflicts of interest and the appearance of conflicts of interest;” nonetheless, the code does allow a member to own a financial interest in a client.

The viewpoints: Again, the interviews uncovered some significant differences of opinion. Barkley felt comfortable with the arrangements described in the question as long as there was adequate disclosure. Butler was comfortable if the firm did not also actively trade in the debt of the client. McKinley, Smith, Van der Stede and VanLeuven, however, were comfortable only if such a firm did not provide debt or equity to a client of the “restructuring” firm.

Once again, Allison and Finkbiner saw the issue in a somewhat different light. Allison commented that the arrangement would be unethical because the principals in the firms would be wearing two (or three) different hats. He continued, “There is an inherent conflict between turnaround client, lender, buyer/owner...You can only have one master—your client.”

Finkbiner remarked that a majority of prospective turnaround clients need cash and, “If a turnaround firm has a separate fund to provide money, the prospective client may select the firm for that reason although the firm may not be the best qualified for the job.”

So what?

The above examples illustrate why, in the author’s opinion, it is time—past time—for TMA to reassess its Code of Ethics, not only to address areas of disagreement but also to correct omissions and inconsistencies.

The existing code obviously fails to provide adequate guidance on the matter of incentive compensation. Everyone knows that financial incentives such as compensation based on a percent of sale and “wearing three hats”—turnaround expert, lender, buyer/equity holder—may affect professionals’ behaviors and client outcomes, yet the code is silent when it comes to providing details about which forms of incentive compensation are acceptable, which are not and under what circumstances.

The code also appears to be both inconsistent and contradictory. The examples and viewpoints described above bring those shortcomings into sharp focus. Although the code says, “A member shall avoid conflicts of interest and the appearance of conflicts of interest,” how can one possibly avoid conflicts of interest and the appearance of conflicts of interest while receiving success fees

that may encourage actions not in the client's best interest or owning equity and/or providing funding to a client company?

The code's omissions and inconsistencies have consequences both for clients and for the profession because the code establishes the minimum standard of conduct. What is legal is defined through legislation and litigation. What is ethical, however, is defined by each industry.

As a result, the community's view of corporate renewal professionals depends upon the standards set by TMA as well as upon the work actually performed and results achieved by TMA members. In turn, such standards and performance have an impact on what stakeholders see and what referral sources seek and expect. Kathy Tomlin, CCE, current chairperson of the National Association of Credit Managers (NACM), said that credit managers often do not trust what they hear from turnaround managers. What does her comment say about the industry?

Root cause

What has caused the difficulties with TMA's Code of Ethics described in this article?

First, TMA has no established process in place for regular review of the code. The last review occurred as part of a 2004 legal review by TMA, but 2004 was seven years ago, and a legal review is very different from an outcomes-oriented ethics review. At the time this article was written, there was no formal plan to review the code. In the meantime, practical issues, such as incentive compensation, remain inadequately addressed.

Second, in an ideal world, the code of ethics would reinforce the purpose of the organization, but the purpose of TMA is no longer clear, and its goals and objectives have come under critical scrutiny in recent years. Conversations with TMA members reveal, as did Finkbiner's 2009 TMA *Journal of Corporate Renewal* article, "We are on a dangerous course..." that TMA is facing an identity crisis.

There was a time when the majority of TMA's members were turnaround experts and conferences and conversations focused on turnarounds. As both the organization and circumstances have evolved, that focus has changed substantially.

- Of 43 articles published in *The Journal of Corporate Renewal* between January and September 2011, only six related to turnarounds. No issue on the 2011 editorial calendar had "turnarounds" as its specific theme.
- Although programs scheduled during the 2011 annual conference do include sessions relating to turnarounds, such programs have been the exception rather than the rule in recent years because TMA's priorities have apparently changed from "turnarounds" and "corporate renewal" to "restructuring" and "transactions."
- Practitioners are now most often called "chief restructuring officers" rather than "turnaround experts." A "restructuring," however, does not necessarily lead to a "turnaround."

Third, some people are simply more attuned than others to ethical issues. In general, people view the status quo as being acceptable and do not think, for example, about the nuances of incentive compensation and “success fees” and their impacts on client outcomes.

In addition, as the two examples in this article make clear, individuals hold varying points of view about whether or not professionals can really separate themselves from the manner in which they are compensated. Does full disclosure and advising your client to consult his legal counsel effectively cure all potential ills and prevent ethical transgressions? The jury is still out.

Last, but definitely not least, developing a carefully conceived, outcomes-based code of ethics is just plain difficult.

The issues are complex. Consider, for instance, the issue of incentive compensation. Most people do not consider hourly billings to be “incentive compensation,” but as Mark Shapiro insightfully pointed out during his interview, such billings create “a perverse incentive” because the more hours the professional works, the more money the professional makes.

On top of that, it is difficult to develop a “one-size-fits-all” code when there is such wide diversity among TMA’s members. The organization has changed significantly over the last 20 years. Originally, the majority of TMA members were turnaround practitioners—people who focused on restoring profitability to struggling companies. Today, only 46% of members are turnaround experts; the rest are attorneys, lenders, investors and “other related professionals.”

Yet another challenge is that the definition of what constitutes success for each group of professionals associated with TMA can vary significantly. For example, workout lenders and portfolio managers can now become Certified Turnaround Professionals, but lenders and portfolio managers may have objectives that are markedly different from those of people leading turnarounds. A lender’s success, for instance, might well be a turnaround professional’s failure. Can one code fit all? Perhaps not.

Next steps

1. Re-examine and define clearly TMA’s mission. Is the organization’s mission still, in fact, to be “dedicated to corporate renewal,” or, given the change in membership composition, has its mission changed? Once the mission has been clarified and the goals established, then the organization can begin to develop a code(s) consistent with the goals of TMA and applicable to each key group of professionals.
2. Define a process for re-examining the Code of Ethics.
 - a. In addition to recruiting task force members from within the organization, TMA should consider including professionals from outside the industry, such as business ethics and incentive compensation experts. Outsiders are more likely to

be able to look objectively at the code and to see omissions and inconsistencies. It is difficult for members to police themselves.

- b. A survey of the entire membership is appropriate and necessary because it can provide data about practices, problems and attitudes. A survey might include subjects including, but not limited to
 - i. Purpose of TMA: What should it be?
 - ii. Definition of “corporate renewal”
 - iii. Lists of issues
 - iv. Descriptions of actual practices
 - v. Attitudes about and ramifications of specific practices; e.g., conflicts of interest, impacts created by the broad spectrum of incentive compensation methods
- c. Provide a section of the code devoted specifically to incentive compensation (Other issues may also require separate sections.) with each subset addressed separately; e.g.,
 - i. “Members shall exercise unprejudiced and unbiased judgment on the client’s behalf and shall avoid conflicts of interest and the appearance of conflicts of interest. Because various forms of incentive compensation may interfere with a member’s ability to be objective,
 - 1. Members shall...
 - 2. Members shall not...
 - 3. Disclosure is not enough when.....

The challenge

Business ethics expert John Fraedrich, James N. Jannetides Professor of Business Ethics, Southern Illinois University, Carbondale, summed up the challenge: “What is legal,” he pointed out, “is the floor, not the ceiling.” TMA, as the leading association dedicated to corporate renewal, has an opportunity and an obligation to examine the floor and reach for the ceiling through its Code of Ethics.

There are important issues that need to be resolved, and it is time for TMA to re-evaluate its mission and to fashion a code of ethics that accurately reflects that mission and addresses issues comprehensively and thoughtfully.

The following is a list of ethical issues raised during the interviews for this article.

Incentive compensation

- Percent of sale
- Percent of funds obtained
- Percent of debt forgiven

- Straight hourly rate
- Debt
- Equity
- Referral fees, internal and external

Duties to client and other stakeholders

- Accurately defining client
- Fiduciary duties
- “Pitch and ditch”
- Quality of work
- What to disclose
- When to disclose
- When to withdraw

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