Ethical Issues In Turnaround Engagements Can Affect Results

BY RENEE FELLMAN

In the big picture, the goal of ethical turnaround professionals should be to achieve the best possible outcomes for both clients and stakeholders, but financial incentives used by such professionals can have an impact, favorable or not, on outcomes. The key question is: What should lenders view as ideal financial incentives? The answer is not clear.

The Role Of Financial Incentives

Financial incentives may include hourly rates, compensation for bringing in business, obtaining debt or equity of an entity, hopes for future work, and success and transaction fees such as percent of capital raised, percent of debt forgiven and percent of the sale of a company.

There is broad agreement that financial incentives can affect consultant behavior and client outcomes, but there is no agreement about what constitutes the "perfect" incentive plan. As Nancy Rapoport, Interim Dean and Gordon Silver Professor of Law, William S. Boyd School of Law, University of Nevada, Las Vegas, observed, "The behavior you reward is the behavior you are going to get."

Indeed, the results of a recent survey conducted by CFA (Pages 18, 19, 20) as well as interviews with industry leaders illustrate the wide range of views about which forms of incentive compensation are ethical and likely to produce the best outcomes.

Hourly Fees

Consider, for example, hourly fees. Although almost 90% of survey respondents believe that basing compensation on hourly fees is ethical, interviews revealed that many believe that such fees provide a "perverse incentive."

- Michael Stanley, managing director, Rosenthal & Rosenthal, thinks that fees based on hourly rates can lead professionals to "procrastinate and protract an engagement unnecessarily."
- The Honourable James Farley, Q.C., Counsel, McCarthy Tétrault, observed that although hourly fees may appear "safe" on the surface, they "can be artificially manipulated."
- Dan Dooley, CEO of Morris Anderson, observed, "A natural conflict exists with any hourly billing process (consultants, attorneys, accountants) in that you are rewarded with more hours and fees for a project and a task taking longer." That effect may be magnified in big Chapter 11 cases in which the "whole table of professionals cashes in if somebody throws a monkey wrench into the case."
- In addition, almost every business person has a story to tell about how hourly fees led to individuals or firms accepting work for which they were not qualified, assigning junior, inexperienced staff to projects and preparing reports that added no value.

"Success"/Transaction Fees

So-called "success" and transaction fees include options such as accepting equity and receiving a percent of financial results such as debt forgiven, new capital obtained, increase in operating profits, increase in revenues and sale of entity. Again, there was no agreement among either survey respondents or interviewees.

Percent of Sale

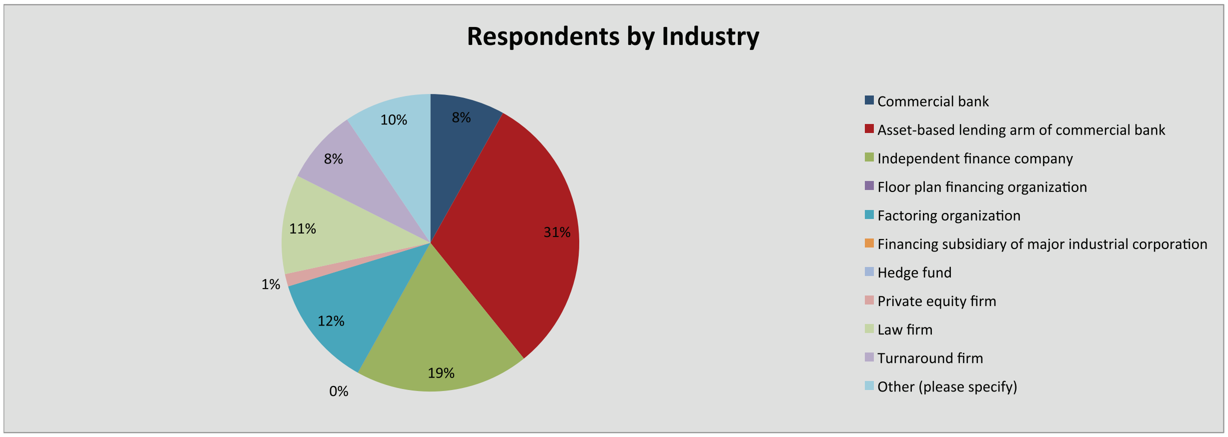
When it comes to the question of which forms of success fee are ethical and likely to lead to optimal outcomes and which are not, percent of sale proved a hot topic.

At one end of the spectrum is Dooley, whose firm bills percent of sale as a transaction fee, who "doesn't see any conflict" and regularly "serves as both consultant and investment banker" to clients.

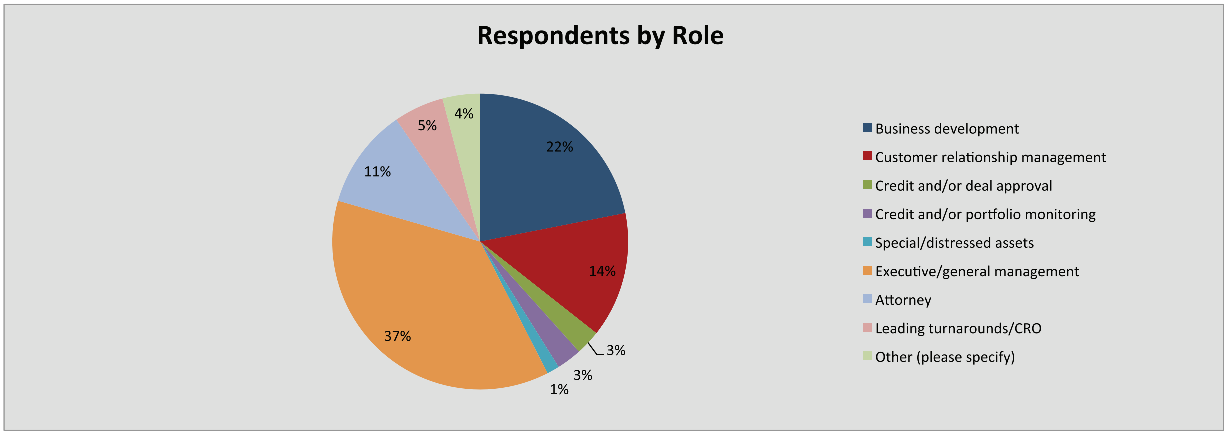
In the middle are those who think that this form of compensation can be appropriate if properly structured.

- Jack Butler, partner at Skadden's corporate restructuring and corporate governance practice, believes percent of sale is ethical and acceptable if the arrangement is fully disclosed and understood at engagement inception.
- Al Smith, head of Perkins Coie's Restructuring Group, and Melissa Kibler Knoll, senior managing director, Mesirow Financial Consulting, believe that this form should be used if, and only if, the financial rewards for turning the company around and selling are approximately the same. "Otherwise," Smith said, "the professional's judgment could easily be skewed in a way that is not in the

Q1. Which of the following best describes your company? (Select only one.)



Q3. What is your primary role?



Q4. Do you believe that it is ethical for a turnaround practitioner/CRO to accept the following forms of incentive compensation?

client's best interest."

- Matt Grimes, executive vice president & Western Region ABL manager, First Capital, also sees this practice as ethical and, in some circumstances, desirable but believes that there "has to be a third party to check to be sure the information is on the up and up" and that effective due diligence by the buyer is critical "because there is the possibility that portrayal of the company may not be honest."

At the opposite end of the spectrum, Marty McKinley, president, Fordham Capital Partners, declared, "There are two things I would not tolerate from turnaround professionals on our referral list, both now and when I was CEO of Wells Fargo Business Credit: taking an equity position and acting as an investment banker. 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."

"The turnaround consultant gains a unique position of confidentiality" but may not be best qualified to manage a sale process. "Most middle-market investment bankers have experience selling in many industries; most turnaround professionals do not."

Stanley concurs, "I admire those professionals that solely do turnarounds and am a bit suspect of those who do both turnarounds and sales of companies."

David Finkbiner, CTP, 2006 winner of The Turnaround of the Year Award from the Turnaround Management Association, shares McKinley's view. Finkbiner's key concern is that the value of the business is at its lowest at the time the turnaround consultant arrives and that "the greatest economic value can be realized if the company can be returned to profitability. Selling the company prematurely leaves value on the table."

Wearing Two Hats

Potential ethical conflicts also arise when a turnaround firm has a subsidiary or separate firm in which its principals participate, either operationally or financially, that provides capital to struggling companies. As with the percent of sale issue, opinions are far from unanimous.

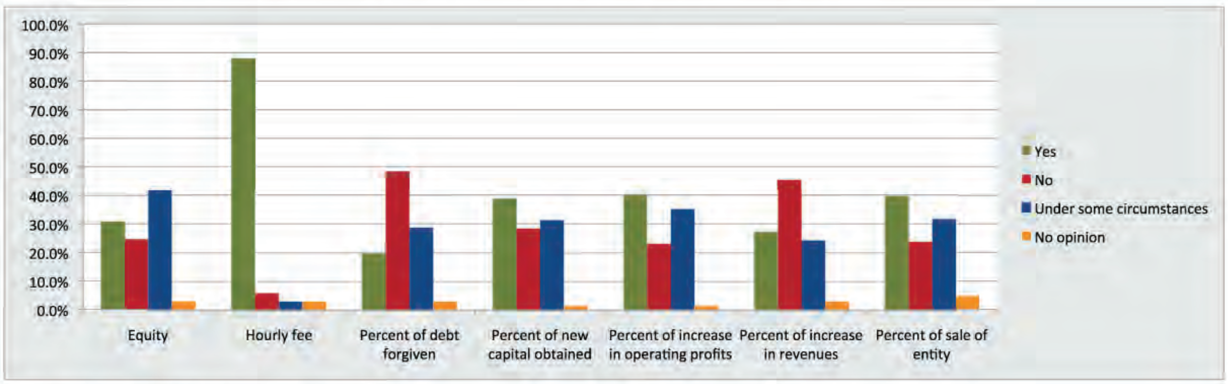
Many felt that "wearing two hats" is fraught with peril.

- Knoll: "From an independence standpoint, if making decisions in a capital-raise process, how can a turnaround professional run an independent process when his or her firm will benefit substantially if the firm is selected?"
- Holly Kaczmarczyk, executive vice president, Head of Business Credit at Wells Fargo Capital Finance: "I believe it could be difficult for a Chief Restructuring Officer (CRO) to operate objectively if she or he is also making an equity investment. The consultant could be conflicted in doing what is right for the company and/or the lenders over the near term while looking for return on investment over a longer timeframe."
- Grimes: "The company has to have their eyes open going in and needs another set of eyes unless they are very sophisticated. Is this a market-rate investment, or are we being taken advantage of?"
- Farley: "In a turnaround situation, clients are often desperate." Wearing two hats can lead to taking advantage of the client.
- Finkbiner agreed: "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 that firm for that reason although the firm may not be the best qualified for the job."
- Dooley: "This is a very obvious conflict of interest. How can you purport to be an objective consultant when you have a direct financial stake in a company?"
- Brent Celestin, managing director of southern California-based Fullcourt Advisors, LLC, just said, "No, such arrangements are not ethical."

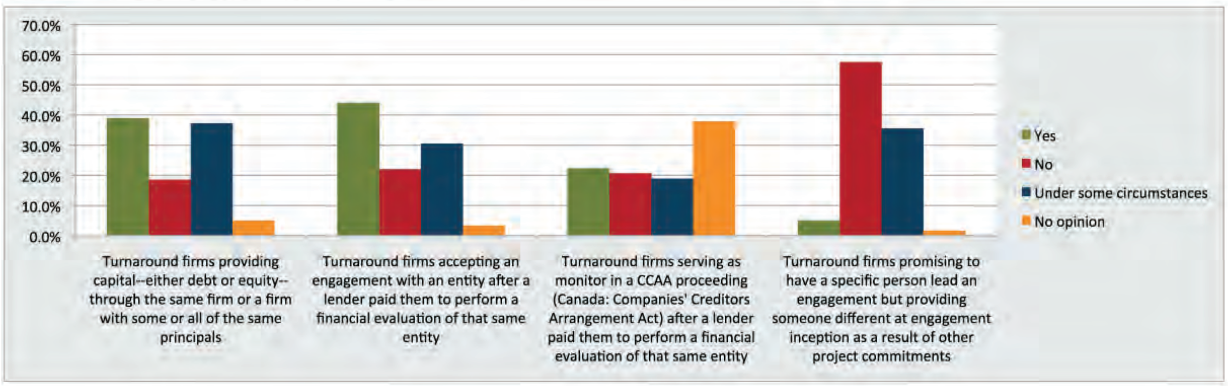
Others Saw A Middle Ground

- Jeffrey A. Wurst, chair of Financial Services, Banking, and Bankruptcy Department and shareholder at Ruskin Moscou Faltischek, believes this kind of arrangement is ethical if it is disclosed up front and if the client is reasonably sophisticated. "If, on the other hand, the consultant sees that the client is over a barrel and manipulates the situation to take advantage of the client, then you have an ethical problem...There is always the potential to be unethical."
- McKinley: "Establishing such an entity is not necessarily unethical, but any creditor to that company, including the lender, has to challenge the objectivity of the decisions

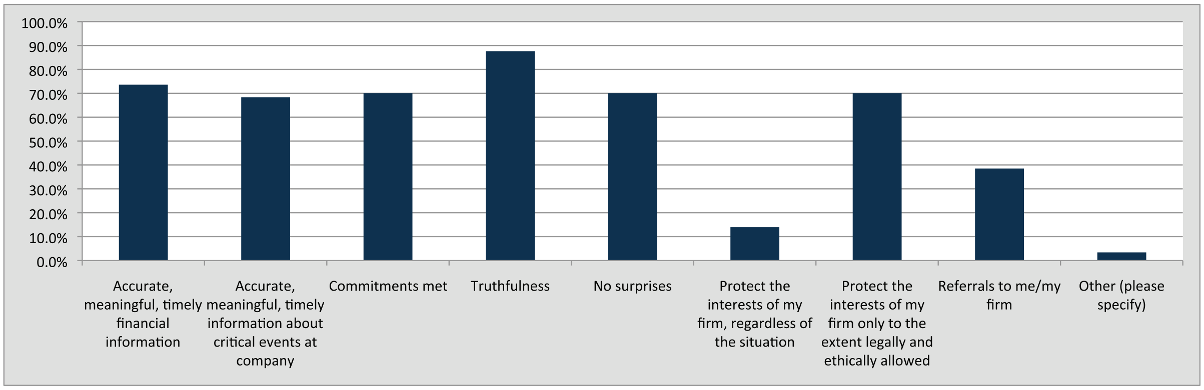
Q4. Do you believe that it is ethical for a turnaround practitioner/CRO to accept the following forms of incentive compensation?



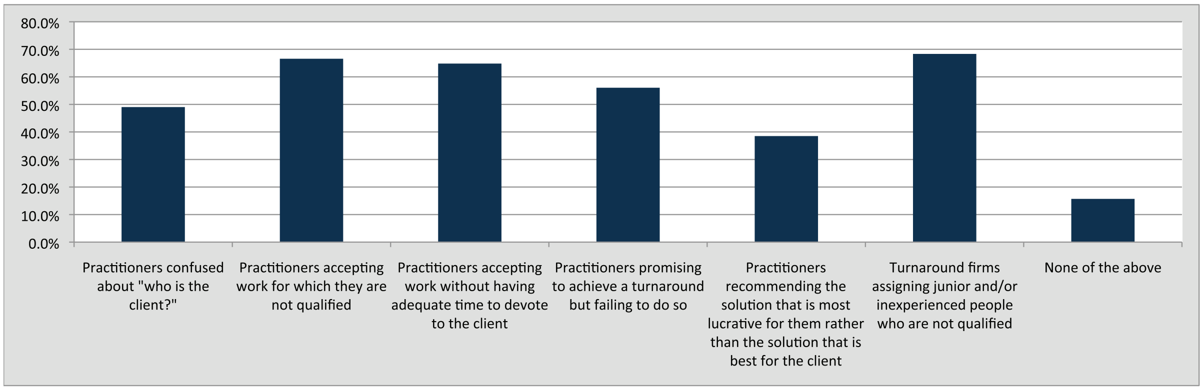
Q6. Which of the following do you see as being ethical?



Q8. When you refer a turnaround consultant to a company, what do you expect from a consultant who would like additional referrals?



Q9. Which of the following have you seen?



the firm is making or recommending to the company....Are the turnaround professionals acting as owners or advisors? To me, as a lender, it's out of bounds.....To avoid a potential conflict of interest, these firms should not provide debt or equity to their own clients."

- Ted Gavin, CTP, managing director and founding partner of Gavin/Solmonese, LLC (G/S), successor to NHB Advisors, explained that his firm does have a subsidiary, NHB Capital Partners (NHBCP), that both sources and provides both debt and equity, but that the firm has exercised great care to ensure that the firm does not trip "The Marty McKinley Trigger." NHBCP will, in limited circumstances, consider providing funding to a G/S client if, and only if, it has received written permission from relevant stakeholders, including the secured lender, and an independent professional firm is responsible for running an open and transparent process. "I can't imagine a situation in which we would find it acceptable to be both the arbiter of the best deal for a client and also be the source of that funding", said Gavin. "We can be either, but not both in the same transaction."

Conclusion

Although both the survey and the interviews demonstrate that opinions about what is ethical or not can vary dramatically, there is no doubt that a consultant's incentive compensation can have an impact on outcomes for clients, lenders and other stakeholders. For that reason, before savvy lenders make referrals, they consider, among other criteria, the kinds of incentive compensation turnaround professionals require. As Michael D. Sharkey, president of Cole Taylor Business Capital, observed, "I have been in the business for 34 years and have not had a problem with ethical behavior by a turnaround professional or CRO, but there is always the potential for problems. That is why we are so careful. " **TSL**

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