Reprinted from
The Journal of Corporate Renewal

MANAGING RISK IN A DOWNTURN

Managing Risk in a Turnaround Engagement

BY MICHAEL TONER, MANAGING PRINCIPAL, AON RISK SERVICES, INC.; ROBERT DANGREMOND, MANAGING DIRECTOR, ALIXPARTNERS; & GAYLE EHRLICH, PARTNER, SULLIVAN AND WORCESTER LLP

There is not much consistency in either the nature of or the focus on risk management inside of turnaround management engagements. Some firms have well-developed and formal protocols, while others leave a great deal of discretion to their consultants. This article provides a brief framework for considering risk management and offers a few practical ideas for improving firm practices.

Good risk management has three facets:

- A well-designed and carefully negotiated engagement or service agreement.
- Well-rehearsed protocols for operating within legally conferred authority.
- Proper liability insurance protection for both consultants and their firms.

Most engagement agreements have common provisions dealing with such issues as scope, compensation, independent contractor relationship, confidentiality, and cancellation. All engagement agreements have limitations of liability and requirements that client companies maintain directors and officers (D&O) liability insurance.

Those same provisions usually require that a client hold the consultant harmless for "acts or omissions." Arbitration and governing law provisions usually are included as well. While every engagement is different and this article does not advance the idea that one agreement should be used in all cases, some critical provisions should be nonnegotiable. These include:

- Language stating explicitly that the consultant is not a fiduciary and does not undertake a fiduciary role with the client, its shareholders, or creditors. Generally, no fiduciary duties are implied under state laws for consultants, unless otherwise agreed upon.
- A provision for limitations on damages specifying the standard as gross negligence and limiting damages to a sum certain that is the direct result of the consultant's gross negligence. The provision also should require that all disputes be arbitrated and that the proceedings and outcome be kept confidential.
- A narrow definition of trade secrets requiring the client to mark any such document as "confidential information."
- Provisions for a running retainer that is replenished as it is drawn down.

> Most engagement agreements have common provisions dealing with such issues as scope, compensation, independent contractor relationship, confidentiality, and cancellation.

Sending a draft of the engagement agreements to the client as early as possible can help set expectations. Although it may seem obvious to most, one must insist on obtaining the signature of someone with the authority to represent and bind a client company's board of directors in the retention of the consultant.

Company articles of incorporation and bylaws and business law confer specific powers, authority, and responsibilities on officers of a corporation. It is essential that consultants be thoroughly versed in these matters and seek counsel if they are not certain how the law should be applied in a particular circumstance. It is also essential that consultants' employers provide guidance to their professionals.

Avoiding Trouble

While providing a complete list of practices is not the intention of this article, there are few steps that are essential to keeping a consultant out of trouble.

Any conflicts of interest, whether real or possible, as well as any preexisting related engagements must be identified and fully vetted. Included in that review should be engagements with a potential client's competitors and/or creditors, and acknowledgements and waivers of any conflict or potential conflict should be obtained.

An effective turnaround team structure, in which all engagements fall under the supervision of a firm partner or managing director should be used. This senior individual retains responsibility for the deliverables and for engagement risk management. Beyond that, an engagement team should prepare and work from a detailed internal work outline that spells out key engagement tasks and team member responsibilities. Both the work outline and the engagement agreement must correspond and should be as detailed as possible about the work the consultant will do.

Many engagement agreements use key verbs such as "assist" or "support" management or client company with A, B, or C to reinforce the idea that the primary responsibility for running the company remains with the client's management. Engagement agreements also should be very direct about requirements for information access.

"Scope creep" is common in turnaround engagements, and it produces two troublesome issues. First, it can render an engagement unprofitable. Second, in the absence of formal agreement and documentation, it can draw consultants into roles and projects not provided for in the engagement agreement and subjecting them to unanticipated liability.

The engagement agreement should specifically note that the consultant is open to other work, but only if it is consistent with the individual's competencies and only after additional

continued on page 2

continued from page 1

tasks are memorialized in the agreement. Most consultants steer clear of requests that resemble anything like certifying audits or offering definitive statements of value.

There is no substitute for regular communication within the turnaround team. Structured periodic progress reviews involving the full engagement team can help ensure that critical tasks are progressing appropriately and will be completed on time. They also help to ensure that work is not off course or outside the formal engagement agreement.

Insurance Protection

Even though a consultant may negotiate proper wording in an engagement agreement and honor the formalities of the organization and its authority, claims of liability can still be advanced. Proper insurance protection, therefore, is essential.

Turnaround consultants have perhaps the most complex set of professional liability exposures of any management consultants. Management consultants operate in the world of tort liability and under the blanket of master-servant protection — that is, their employer is liable for the consultants' mistakes.

But the liability exposure of turnaround consultant increases in management engagements (**Figure 1**). A consultant retains traditional negligence liability but assumes new duties of care and loyalty as a director and/or officer — and these liabilities are individual. Sound advice to turnaround consulting firms is to maintain, at a minimum, both errors and omissions (E&O) and D&O liability insurance at the firm level. Ideally, employment practices liability insurance should be in place as well.

If possible, these policies should be purchased from the same insurer. Claims against consultants and their firms are likely to state causes of actions based on torts or breach of corporate duties. Purchasing both types of coverage through a single insurer can help prevent claims responsibility disputes. If using a single insurer is not possible, a firm should work with a technically qualified broker/agent who can coordinate the coverage grants and exclusions of the two policies. This can be complex, but doing it poorly may result in gaps or overlaps in coverage and ultimately rancorous and contested claims.

Figure 1: The Liability Metamorphosis of Turnaround Consultants

Errors and omissions coverage should be tailored to a firm's specific needs. The larger the consulting firm, the more likely it is that its consulting offerings are diverse and the more willing insurers will be to manuscript policy language. A firm should avoid narrow definitions of "covered services." If an insurer insists on a listing of insured consulting services, "omnibus" language should be added stating that coverage applies to the listed services and any other services the consultant provides, subject only to policy exclusions. The burden should be on the insurer to exclude coverage, not on a consulting firm to include coverage.

If a consulting firm uses independent contractors or if its employed consultants operate as limited liability companies (LLCs), it should pay careful attention to the policy definitions of "insured persons" to ensure that independent contractors are included.

A firm should maintain outside directorship liability (ODL) on its D&O policy. That coverage should respond excess of client company coverage and indemnifications, and there should be no warranty of good or collectible primary insurance at the company level.

If a consulting firm uses independent contractors or if its employed consultants operate as limited liability companies (LLCs), it should pay careful attention to the policy definitions of "insured persons" to ensure that independent contractors are included. Coverage for any LLCs through which consultants operate, limited to work performed on the firm's behalf, also should be in place.

Consultants should not walk away from an engagement because the company has impaired, inadequate, or no D&O coverage. New products in the market can insulate consultants and their firms from primary liability in an engagement and permit the consultant to accept the work.

Having sound risk management in place is not a competitive advantage. But a failure to institute such practices may be a competitive threat. CR

Robert N. Dangremond, CTP (top photo), is a managing director in the New York office of AlixPartners, Gayle P. Ehrlich (center photo) is a partner with Sullivan & Worcester LLP, and Michael E. Toner (bottom photo) is a managing principal with Aon Risk Services, Inc. Dangremond specializes in debtor representation, bankruptcy, and corporate renewal. Ehrlich represents clients nationally in restructurings, business litigation, and in the acquisition and sale of businesses. She also serves as TMA International's corporate secretary. Toner is the founder and chief executive of Aon's Turnaround and Restructuring Practice, which provides turnaround support for consulting, legal, lending, and accounting professionals. Dangremond can be reached at (212) 490-2500 or bdangremond@alixpartners.com, Ehrlich at (617) 338-2453 or gehrlich@sandw.com, and Toner at (617) 457-7603 or mike_toner@aon.com.