

THE INSTITUTES OF CERTIFIED MANAGEMENT CONSULTANTS IN CANADA

PAYMENT FOR MANAGEMENT CONSULTING ENGAGEMENT FEES IN THE FORM OF SHARES OF THE CLIENT COMPANY

- an Innovative Opportunity for Clients and Consultants and an Emergent Issue Relative to Professional Conduct

I have been asked to set down my opinion on how the Institutes' Code of Professional Conduct applies in the circumstances described below: when the management consultant receives part or all of the professional fees for a client engagement in the form of a beneficial equity interest in the assets and future earnings of the client enterprise.

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The nature of the opportunity

Discoveries, inventions and applied research are exploding in the fields of computing, telecommunications, electronically based business, biotechnology and other "new economy" industries. Numberless enterprises are springing up to capitalize on emerging and commercially viable developments in these industries.

Start-up ventures in these fields often are launched by researchers, technicians and non-business professionals, whose skills are focused on products, product development and associated customers. Their forte is conceiving the brilliant new idea that meets or creates a new market need. Some of these founders may have entrepreneurial talents, but many of them have little or no experience in management.

These ventures frequently have a strong demand for managerial and administrative capabilities to complement the founders' technical and perhaps entrepreneurial competencies. That demand sometimes is satisfied by recruiting experienced executives and staffs to fill financial, human resource, sales and general management roles. In other cases, the founding group may rely to varying degrees on retaining outside consultants, investment bankers, accountants, lawyers and other professional resources to get the venture off the ground and to carry it through its pioneering years.

In the early stages of their lives, these ventures often have highly limited financial resources to draw upon. Money is tight, until in due course an Initial Public Offering, hopefully successful, brings in a waterfall of cash. In those beginning days, the founders often cannot afford to pay substantial professional fees in cash. They may seek in every way possible to get maximum value from their small bank accounts. Any professional or commercial assistance that can produce immediate results without a corresponding disbursement of cash tends to find strong favour with the founders. These ventures usually are inherently speculative, and saving money today at a cost of sharing the longer-run benefits and risks can be attractive to them as a practical trade-off.

Further, the client may believe that the consultant's commitment and motivation are strengthened by having an economic stake in the client's success through an equity holding.

Equally, the (albeit hazardous) prospect of sharing in a potential bonanza, at the cost of giving up current cash income, can be very enticing to consultants and other professionals who are not averse to risk. This can be construed as an effective way of participating in the success which the professional has helped to generate, and a proper and prospectively profitable way of marketing the consultant's expertise. It can create and sustain a mutually valuable long-term relationship with the client. It could also be viewed as a very effective means of attracting and retaining employees, if the consultant is able to offer staff the opportunity to participate in the earnings and capital gains from shares in clients as an incentive to join or stay with the consulting practice.

So: there can be a community of interests, with concrete benefits to both the client and the consultant, giving rise to arrangements under which a proportion of the engagement fees of a management consultant or other professional is agreed to be paid in a calculated number of shares of capital stock in the client venture. Common phrases adopted to encapsulate such schemes are: fee-in-shares, stock-for-fees and equity-as-payment.

Arrangements of this kind may be generated most frequently in start-up, often small, ventures in the "new economy". But they need by no means be limited to such situations. Enterprises may be large or small. They may be in any industry. They may be new or long-established. They may be in the early stages of formation, or planning an Initial Public Offering, or already listed and publicly traded. The consultant entity participating may be a sole practitioner, a small firm or a large and perhaps global firm. The common factor is the desire of the client to remunerate the consultant in part or in whole through equity, and the willingness of the consultant to be paid in that manner.

Our Code of Professional Conduct

The preamble to the Code states that its purpose is to identify those professional obligations serving to protect the public in general and the client in particular. It says that it also identifies the expectations of members with respect to other members and the profession.

In considering the applicability of the Code to the fee-in-shares arrangement, it is well to remember that the Code is grounded in what is best for the client and the public, first and foremost. The Code does not function in a vacuum. Beneficial innovations in the management consulting profession must be desirable to the clients, not inimical to the public interest, satisfactory to the consultants and not unbecoming to the profession. Any innovation that meets these tests should prima facie be unobjectionable under our Code. The Code should not be an impediment to adopting a sound business practice that benefits all the parties involved.

The directly pertinent Sections of the Code are five in number. They are:

4.01: stating that a member shall act in the best interests of the client, providing professional services with integrity, objectivity and independence.

4.08: saying that a member shall refrain from serving a client under terms or conditions which impair independence.

4.05: requiring that a member:

- establish fee arrangements in advance with a client ... and inform all relevant parties when such arrangements may impair or be seen to impair the objectivity or independence of the member
- not enter into fee arrangements which have the potential to compromise the member's integrity or the quality of service rendered.

2.04: calling for a member to:

- behave in a manner which maintains the good reputation of the profession and its ability to serve the public interest
- avoid activities that adversely affect the quality of that member's professional advice
- not carry on business which clearly detracts from the member's professional status.

1.01: requiring a member to act in accordance with the applicable legislation and laws.

The Statements of Interpretation accompanying each Section of the Code furnish guidelines that are more specific than the related Sections. Three interpretive Statements contain elements that are relevant to the fee-in-shares arrangement:

4.01.1: Members shall recognize the interests of the client organization, overall, as paramount in every assignment.

4.05.2 (a lengthy Statement which is repeated under three other Sections including 4.01):

Particular care should be taken with client requests for quantification of intended benefits or results, or for risk-taking approaches where the total fees for the member will be related to the results or benefits realized by specifying as a minimum:

- the client's responsibilities related to the intended benefits or results;
- identifying the risks and assumptions associated with realizing the intended benefits or results;
- identifying the measures to be used; and
- clearly communicating these elements to the client.

4.05.5: members shall not undertake assignments of a scale or magnitude where the proposed fee arrangements are such that they represent a substantial business risk for the client.

Independence ... objectivity

From the listing of the applicable Sections of the Code it is clear that the interrelated requirements of independence and objectivity are central to the question of whether fee-in-shares remuneration is acceptable under the Code. Do such covenants impair the consultant's independence or objectivity, and therefore contravene the Code?

It is helpful to consider just what those two terms mean. The Canadian Oxford Dictionary defines them in this way:

independence: not depending on authority or control; not depending on another person for one's opinion or livelihood; not depending on something else for its validity, efficiency, value, etc; impartiality: conducted or originating outside a given institution, group, etc.

objectivity: not influenced by feelings or by personal bias (a predisposition or prejudice).

To be independent in the consulting context means that the consultant is not controlled by the client; that the consultant is in a position to render professional services in the way the consultant sees fit; and that the consultant is free to withdraw from the assignment if undue influence from the client would impair the consultant's professional judgment. Further, to be independent requires that the consultant not be a member of the client's authority structure which will make decisions on the consultant's proposals, advice or recommendations.

To be objective in the consulting setting means that the consultant must be faithful to the arrangement with the client, making the client's interests paramount. Consultants must not let their professional work, judgement, opinions or recommendations be clouded by the personal interests of the consultant. Accordingly, their financial stake in the fees, however determined, of an engagement should not be so significant as to bias their professional work, or appear to be liable to do so. Objectivity primarily is a state of mind, but there is also the requirement that the consultant manifestly be objective from the viewpoint of the client and others affected by the assignment, and without a conflict of interest; any impairment, actual or perceived, must be appropriately disclosed.

Precedents from traditional and other current types of consulting engagements

Consulting assignments run the gamut from advice to fact-finding to recommendation to design to implementation to operation. Fees may range from small amounts for a few hours' work to multi-million dollar contracts extending over many years. Always, the consultant is expected to serve the client in the way that best will meet the agreed purpose of the assignment from the client's standpoint.

In every fee-paying professional assignment, the very fact of the presence of a fee means that consultants are not in principle totally independent of the client, since their personal financial interests and professional futures are influenced by the assignment outcome. Nevertheless, in the vast majority of instances the consultants can function with de facto independence, performing their work objectively and without personal bias.

If the assignment demands a skilled professional evaluation of a problem and development of a solution, the attitude the consultant brings to the work must reflect that. If the assignment calls for the consultant to be a professional advocate for a project the client wishes to conduct or to promote, it behooves the consultant to marshal the evidence in support of the project while downplaying its negative features. In either kind of assignment, the consultant must act with independence and objectivity.

Some assignments require the consultant to undertake a neutral, impersonal, fact-based study of a client matter, with the consultant's report being supplied to one or more external parties such as a bank or regulator. In such cases it is incumbent upon the consultant to ensure that the fee arrangements cannot be construed to potentially bias the consultant's report, and that affected outside parties are informed of any fee or other agreements that those parties might construe to impair independence or objectivity.

Contingency fees are fees payable in relation to determined benefits or results for the client organization, measured in absolute or percentage amounts. At one time these were deemed to contravene the Code of Professional Conduct of the Institutes and the Rules of Professional Conduct of the chartered accounting profession. Now, such fee terms are acceptable to both the consulting and accounting professions, under defined circumstances (under our Code, in Interpretation 4.05.2, above).

Many consultants are entering into role-sharing structures, accompanied by fee-sharing formulas, with other consultants or with their clients. The vehicles for doing so may be project consortiums, joint ventures, alliances, strategic partnerships or system development and marketing projects. Further, consultants are taking on outsourcing contracts, assuming responsibility for operating a specific, usually non-core function for the client organization. None of these varied processes and structures in itself contravenes the Code. The consultants must act as independents, and undertake their roles objectively. The parties affected must be under no illusions as to the roles, commitments and economic interests of the respective consultants.

Relative to Code Section 2.04, non-traditional arrangements of the type described above do not, in and of themselves, bring any dishonour upon the profession, and are not on that account beyond the pale of acceptable practices. It goes without saying that the consultant under any form of fee determination must abide by all applicable legislation: Code Section 1.01.

In every assignment, regardless of type, the degree of involvement, and the proportion of the consultant's fees to total personal or firm income, should not be so high as to impair, or be perceived to impair, independence or objectivity. If that does not hold, the client and other parties affected must be told, and it may be necessary for the consultant to resign from the assignment.

It is worthy of mention that the Securities and Exchange Commission in the United States has in progress a lengthy inquiry into, and hearings on, the standards of independence for public accounting firms that audit the publicly traded companies which are registered with the Commission. The SEC's expressed intention is to prohibit the undertaking by those firms of a wide variety of identified consulting and other professional services for their audit clients. How this will play out remains to be seen, but there seems little doubt that the restrictions will be severe. This already has led some of the Big Five accounting firms to proceed with plans to split their accounting and consulting (however delineated) practices into two or more separate firms.

Many Canadian companies are SEC registrants, and the tightened rules would apply to their auditors here. The Ontario Securities Commission has raised similar concerns about independence of the accounting firms whose clients are registered with the OSC; this could lead to restrictions in Canada akin to those likely to be adopted in the United States. The consulting practices that are spun off would not be subject to Commission limitations, and would be free to entertain conventional and new types of fee arrangements. The accounting practices would be barred from conducting a stated list of consulting services for audit clients, but probably would be allowed to perform those and other types of consulting services for non-audit clients, provided that doing so does not run afoul of independence requirements opposite any audit client.

Applicability to fee-in-shares assignments

What parallels can we draw from those various types of assignments - problem-solving, advocacy, third-party recipients, contingency based, shared roles and outsourcing - in considering the meaning of the Code for payment through client shares?

It transpires that the same ground rules apply to fee-in-shares arrangements; new rules do not have to be devised.

Regardless of the method of paying the fee, for neutral studies with a report going to a third party which may act on the basis of the study results, it is vital that the consultant ensure that the fee basis, from the standpoint of a reasonable observer, cannot be taken to void the consultant's objectivity and that the third parties affected are made properly aware of how the consultant is paid.

Similarly, the fee-in-shares situation fits quite readily within the contingency fee basis covered by Interpretation 4.05.2. That Statement encompasses quantification of intended benefits or results, and risk-sharing approaches where fees are related to the benefits or results. Share values may be construed as the ultimate method of computing the benefits or results from a consulting assignment.

Laissez faire does not apply, however. Safeguards and limits are needed, to protect both the client and the consultant. Interpretation 4.05.5 of the Code says that members should not undertake assignments of a size where the fee arrangements represent a substantial business risk for the client; the consultant must be satisfied that this is so. In a parallel vein, the fee-in-shares arrangement should not be so significant to the consultant's practice success and personal wealth that, in the eyes of a reasonable observer, the credibility of the consultant as an objective professional has become compromised.

Limits, therefore, are appropriate. There are no set factors or percentages applicable across the board. But the consultant should establish upper limits on the size of assignments to be taken under fee-in-shares conditions, and on the percentage of the client's shares to be owned. The consultant may wish to receive at least a set minimum proportion of its expected fee in cash rather than in shares, although there is no intrinsic reason to do so.

The consultant also must be prepared to judge the degree of risk to the practice and financial resources; the size and risk of the assignment must not be so high that the consulting practice or its people are in serious financial difficulty if the company is unsuccessful or fails, and the shares turn out to have little or no value. Nor should the assignment be so significant to the consultant that the assignment work is influenced by short-term share value considerations to the detriment of the long-term success of the client.

Once the consultant has undertaken for the client an assignment remunerated by fee-in-shares, there are certain other kinds of assignments that the consultant and other people in the same practice should be precluded from undertaking. These are customarily of a statutory, legal or regulatory nature, or are to be relied upon by third parties as the outcome of an examination under the presumption that it was conducted by an independent, neutral professional. No matter how strong the firewall between assignments, a professional practice having entered into fee-in-shares for one assignment should not undertake a statutory financial audit, or purport to be independent opposite third-party financiers or regulators in developing financing proposals or forecasts.

When asked to accept an assignment for a competitor of a client from which the consultant has received shares, the consultant must weigh the competitor's need for independence in that new engagement, and may find it is requisite to decline the work on that account.

It can be expected that the prospective tightening of conflict-of-interest rules by the SEC and probably the OSC will mean that advisory services, including any consulting services still allowed, performed by accounting firms for their audit clients cannot be paid for under contingency billing or fee-in-shares contracts.

Being on the Board of Directors

At times, the consultant might be invited to go on the Board of Directors of the client. This moves the consultant from an advisory position to a decision-making one, since the Board oversees and controls the company's policies, strategies, people and results. The consultant thus is not independent, and should not undertake any assignment (such as developing a financing proposal) where third parties receiving the assignment report intend to rely on that report and so require that the work be undertaken by an independent consultant. Even in that kind of assignment, however, the constraints faced by the consultant are determined not by some immutable principle of theory, but by the needs and wishes of the client and affected third parties, coupled with transparent disclosure of relationships and interests.

Proceeding with fee-in-shares arrangements

The consultant who is willing to contemplate fee-in-shares consulting assignments should think through the situation and the implications for the consulting practice, and lay down guidelines.

Some of the factors are:

- for what types of assignments, clients and industries will such arrangements be considered?
- under what client circumstances will such arrangements be accepted?
- will the consultant actively seek opportunities, or only respond to client overtures?
- can the consultant effectively judge the merits and viability of the client's business plan, and the quality of client management, directly or through the findings of other professionals?
- what will be the impact on other parts of the practice?
- what conditions and limits will apply, in such elements as stage of the venture client's development, what combination of cash and shares in settlement of the fee, maximum proportion of the consultant's practice, maximum proportion of the client's capital stock, etc.
- who in the practice will examine the opportunity, _____ and who will authorize proceeding _____ with it?
- how will the consultant ensure that the shares are held and handled in accordance with securities _____ laws, at the time of contracting, at the time of issue, and subsequently?
- when will the shares vest in the consultant, who will hold them in escrow or otherwise in a trust until then, and what restrictions are there on disposing of them?
- how will income and capital gains from the shares be divided fairly among current and future owners of the practice?
- what are the income tax implications for the practice and its owners, now and later?
- what legal advice will be obtained to see that the consultant's interests are adequately protected?
- what are the prospective effects upon the consulting practice profitability and consultant's personal wealth?
- what overall boundaries and financial limits for the consulting practice will be placed upon acceptance of these opportunities?

In essence

With safeguards in place, clarity in the consultant's roles and relationships, and understanding of those by the client and affected third parties, fee-in-shares arrangements are acceptable, in my opinion, under the Institutes' Code of Professional Conduct.