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Negotiating Investment Banking M&A Engagement Letters: Keeping the Investment Bank Incentivized While Protecting Your Interests

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Congratulations … we hope. Your company has battled through the past several years of troubled economic times and has come out on the other side stronger for it. Cautious investors who have been hoarding their cash are slowly testing the investment waters, and a flurry of investment bankers are rummaging through the remnants looking for the diamond in the rough that entices some of this sidelined money back into the markets. One of the wiser investment bankers now remembered a distant meeting with you and has realized, rightfully so, that your company's recent EBITDA growth and margin expansion make you a very appealing candidate to a potential buyer. The investment banker has approached your company, laid out a compelling case for why a sale at this time might make sense for your company, and has convinced you to plant a "for sale" sign in your corporate offices and test the market. The investment banker has served up his firm's "standard engagement letter," and asked that you sign it so you can partner up and kick off the process.

At this point you are conflicted — you know this investment banker is supposed to be "on your side" and "working for you" and you certainly do not want to start the relationship on the wrong foot. At the same time, there are a number of provisions in the engagement letter that make you uneasy, and you wonder whether they are customary or if there is room for negotiation. Beyond some of the obvious negotiable points (such as the amount of the success fee), we highlight below several aspects of the engagement letter that should be evaluated with care and that have room for negotiation.

Fees

Without going into all the issues related to the investment banker's fee, there are a few points that come up frequently in discussions with investment bankers, such as the possibility of a progressive fee structure and the timing of payments to the investment banker, which are worth addressing here. The fee payable to the investment banker in an engagement letter is most likely calculated as a percentage of the price for which the company is sold. While an investment banker should always be working to get the company the greatest value in the sale, it is not uncommon to tweak the fee structure to give the bank some extra encouragement. One way to accomplish this is through a progressive fee schedule (sometimes referred to as a "Reverse Lehman" formula), where the success fee percentage increases as the sale price crosses certain thresholds. Under certain circumstances minimum and/or maximum fees might be appropriate. While some banks will insist on a minimum fee, it is nevertheless important to negotiate the amount of the minimum fee to ensure that the bank remains properly incentivized to get its client the best deal.

Also worth considering are provisions in the engagement letter that relate to the timing and manner of payment of the investment banker's fees. It is possible that a potential buyer makes an offer for a company that its owners think is too low, and they counter with a higher price. For example, the buyer may have expressed some concern about whether the company's projected future revenue levels are realistic, but has indicated a willingness to pay an additional amount for the company following the sale **if** the projections pan out — commonly referred to as an earnout. In this situation, the company probably would not want its investment banker to collect a fee at the time of closing on the earnout component — it is reasonable that the banker should only get paid if the company/owners get paid. To account for this, the engagement letter should specify that the investment banker does not get paid its fee on the earnout **unless** and **until** the earnout component of the purchase price is actually earned **and paid**. If the investment banker balks at this position, as a compromise, the parties might agree that the banker will receive its fee at the closing of the transaction based on a transaction value that factors in receipt of only a portion of the earnout amount. In addition, if the investment banker is amenable to the idea, it may be prudent to specify that the banker gets paid in the same form of consideration as the company/owners get paid, so that, for instance, if the company/owners receive equity in the buyer as consideration, the company/owners do not have to come up with cash to pay the banker.

In addition, while it is common for an investment banker to receive an upfront retainer and a success fee upon consummation of a transaction, occasionally an engagement letter will call for milestone payments at other points in time. For instance, the investment banker may have included a provision in the engagement letter that calls for payment of a portion of its fee upon the signing of a definitive transaction document, and the balance of its fee upon consummation of the transaction. If the banker has proposed a structure that incorporates milestone payments, and that is something a company is willing to consider, it is best to ensure that the milestone payments are only earned upon the achievement of legally meaningful and objective events. For instance, if the banker has asked for a milestone payment upon the signing of a letter of intent or term sheet, a company will likely want to resist this point, as letters of intent and term sheets are often nonbinding. While a letter of intent may be meaningful from a moral perspective, it typically only requires the parties to continue to negotiate in good faith, which would leave the company paying an investment banker fee with no assurance that it actually has a binding transaction. Most investment bankers will agree to offset any amounts owed for a success fee against the company's retainer. Finally, the banker may propose that its fee be calculated off a base that includes "value" over and above the cash purchase price, such as lease payments (if there is an affiliated landlord) or the value of compensation under employment agreements entered into in connection with closing. These types of items should be viewed with skepticism and negotiated with great care.

Carveouts from the Definition of "Transactions"

The engagement letter will typically provide that the investment banker will be entitled to its fee upon consummation of a "transaction." In a sale context, the term "transaction" will usually be defined to cover the sale of all or part of the capital stock of a company, the merger of a company with an acquirer, or a purchaser's acquisition of all or substantially all of a company's assets. It is also not uncommon for the term "transaction" to be defined even broader, and to pick up capital raising transactions such as issuances of debt and equity securities. Depending on a company's circumstances, however, there may be a number of transactions that it will want carved out from the definition of "transactions."

Suppose a company has been in very preliminary talks for several months with one of its suppliers about the possibility of combining the two companies to take advantage of synergies. If, after the investment banker has been engaged, these talks become more serious and a decision is made to pursue a combination with the supplier, arguably the investment banker should not be entitled to a fee. After all, this was a potential transaction the company identified and nurtured on its own prior to discussions with the investment banker. It is not uncommon, therefore, to list on a schedule to the engagement letter a number of parties with whom the company has already had discussions about a sale transaction and to specify that a sale to, or combination with, any of those listed entities will not be considered a "transaction" for which the investment banker will be entitled to a fee. Remembering of course that the goal is to keep the investment banker working hard on the company's behalf, the company might instead provide for a reduced fee to the banker in connection with a sale to a party listed on the schedule.

Alternatively, imagine a situation where several years ago, as part of a capital infusion from a minority investor, a company granted that minority investor an option to purchase a 51 percent stake in the company at a set price in the future. The company will likely want its engagement letter to make clear that if the minority investor exercises its option during the term of the engagement with the investment banker (or during the tail period, discussed below), then the banker will not be entitled to collect a fee for that transaction.

Services

One important component in an engagement letter is a description of the services that the investment banker will provide in connection with the engagement. This list of services may include reviewing a company's financials and comparing them to industry data, identifying and approaching potential purchasers, coordinating potential buyers' due diligence efforts and assisting in negotiations. If the investment banker has not already offered to do so, and it is not addressed in the engagement letter, it is important to reach an agreement at this stage on who will be responsible for drafting the disclosure document that will be used to market the company. If the engagement letter is not clear as to who will bear responsibility for preparation of marketing materials, the investment banker might request an additional fee if the company enlists its assistance with such tasks down the road. The services provision of the engagement letter should also make clear that the company has the final decision on all important transaction matters, such as final approval of marketing materials, who the bank shops the company to, whether to engage a bidder in further negotiations and, most importantly, whether to accept or reject a purchase offer.

The Banker's Expenses

The engagement letter likely calls for the client to reimburse the investment bank for all expenses it incurs in furtherance of the engagement. While a company will not have much luck asking the investment bank to cover its own expenses, there is often room to establish a cap on out-of-pocket expenses that the investment banker will not exceed without first obtaining the client's consent. This cap can be a monthly cap or an aggregate cap. Alternatively, the parties might agree that the investment banker will not incur any individual out-of-pocket expenses in excess of a certain amount without first obtaining the company's consent, though before agreeing to a provision such as this, it is important to note that it affords the investment banker some wiggle room to divide what may seem like one expense that crosses the agreed-upon threshold into multiple separate expenses none of which reach the threshold.

Term, Termination and Tail

Most investment banks structure the term of the engagement in such a way that it will perpetually renew absent some affirmative action by the company to terminate the engagement. For instance, the engagement letter might provide that the engagement lasts for six months, but that it automatically renews for additional successive one-month periods if neither party provides written notice of its intent to terminate the engagement. Provisions such as this are notorious for catching up with unwitting companies who forget to notify their investment banker of their intent to terminate the engagement and wind up on the hook for a hefty commission when they enter into an unrelated transaction some years down the road. Further, as discussed in detail below regarding "tail periods," sending the termination notice one month in advance of signing up for the new transaction is unlikely sufficient to steer clear of paying the investment banker its windfall. Rather than agree to the investment bank's standard formulation of the termination clause, it may be preferable to propose that the engagement automatically terminates after a set number of months unless the parties mutually agree in writing to extend the term of the engagement.

In addition, and almost without fail, an investment banker will insist that the engagement letter include a "tail period." The tail period is a period of time after the termination of the engagement during which, upon the completion of a transaction, the investment banker would still be entitled to its fee. While it is fairly common to negotiate the duration of the tail period, there are other features of the tail that can often be revised to a company's benefit. Frequently, the investment banker will propose that the phrase "transaction" means the same thing for purposes of the scope of its own engagement as well as the tail period. Depending on the amount of leverage a company has with its investment banker, the company may have luck narrowing the scope of the types of "transactions" that would be covered by the tail. For instance, the investment banker might agree that it will only receive a payment for consummation of a transaction in the tail period if that transaction is with a third party who was solicited by the investment banker during its engagement and received a copy of the company's disclosure document. Depending on the circumstances, it might even be appropriate to limit the investment banker's fee in the tail period to cover transactions with parties who were brought to the company's attention by the investment banker and with whom the company engaged in "active and substantive negotiations" (which is a phrase that should be defined in the engagement letter). To limit the potential for disputes down the road, it is also not uncommon for the engagement letter to provide that upon termination, the investment banker must provide the company with a list of those parties who fit within the "active and substantive negotiations" standard.

Indemnification

Probably the most confusing part of any engagement letter for a company is the indemnification provision, which is notorious for being filled with run-on sentences that can extend for up to half a page. If the indemnification provision is not contained in the body of the engagement letter, it will be attached as an annex or exhibit to the main letter. In general, there is relatively little room for negotiation of the indemnification provision. The investment banker will generally insist on being indemnified for any liability it incurs in connection with or as a result of the engagement other than any liability resulting from its own willful misconduct or gross negligence. This standard is common across banks, and it would be highly unusual for a bank to agree to accept liability for any conduct on its part that does not rise to this level. Investment banks are of the view that it is someone else's company they are marketing, and therefore the company needs to be responsible for what is said. While a company may have some success tinkering with the terms of the indemnification provision on the margins, banks are typically very reluctant to deviate from their standard language.

Conclusion

While it is no doubt important for a company to maintain a positive and collaborative relationship with its investment banker, that does not mean the company should simply accept the initial draft of the engagement letter that its investment banker serves up without negotiating certain fundamental points. In fact, discussing the points set forth above prior to signing of the engagement letter will help the parties avoid disputes during the course of the engagement, which should help foster a productive working relationship. An investment banker can add tremendous value to a sale process by helping to demonstrate a company's value, identifying and engaging potential buyers and assisting with negotiations; however, before engaging an investment banker, it is important that a company do so on reasonable terms that strike an appropriate balance between incentivizing the banker and protecting certain of the company's legitimate interests. A reputable banker will understand and appreciate the company's needs for many of the protections discussed in this article, and will probably even respect the company more as a client if the company recognizes and can articulate its need for these protections.

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