



NEGOTIATING M&A ENGAGEMENT LETTERS

This Checklist sets out the most important sections of a financial advisor engagement letter and lists negotiating points for both the buyer and the advisor in connection with an M&A transaction.

A financial advisor engagement letter is a contract that sets out the terms of the relationship between a buyer or seller in an M&A transaction and its financial advisor. This Checklist focuses on engagement letters between buyers and their financial advisors. Even before a buyer contacts a seller and enters into a confidentiality agreement, the buyer usually retains a financial advisor to assist the buyer in achieving its goals.

The engagement letter is an important document for both parties. The advisor must pay careful attention to how much and when it will be compensated for its services. The buyer must make sure that the terms of the engagement letter do not obligate the buyer beyond what it expected. While many of the provisions are standard and customary, certain provisions can be negotiated.

This Checklist sets out the most important sections of a financial advisor engagement letter. It explains each of the key issues in the agreement and lists negotiating points for both the buyer and the advisor. A glossary of terms frequently used in engagement letters is also included (see *Box, Glossary*).



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KEY ISSUES

Issue	Advisor's Position	Buyer's Position
Scope of Services	<ul style="list-style-type: none"> □ Include a general description of its M&A services without specific commitments. □ Seek to have the buyer retain the advisor for likely additional services (for example, financing for the transaction) and give an option or right of first refusal for future services (like financings). □ Avoid having additional services covered in the basic fee (for example, a fairness opinion without an additional fee). 	<ul style="list-style-type: none"> □ Indicate the services that the advisor will provide, such as identifying (and contacting) a suitable target, analyzing and proposing transaction structures, analyzing the best price range with comparative analyses and determining the right price for the transaction. □ Include a provision that other services the buyer "considers necessary or reasonably requests" will be provided without additional cost (for example, a fairness opinion). □ Limit the advisor's right to provide other services not directly related to the contemplated transaction so that the buyer may benefit from competition among other firms (for example, financing).
Definition of Transaction	<ul style="list-style-type: none"> □ Define "transaction" broadly to include a large universe of deal structures, such as minority stake purchases, joint ventures, collaborations and licenses that might arise from the engagement. 	<ul style="list-style-type: none"> □ Define "transaction" narrowly to exclude transactions other than change in control acquisitions (for example, a 100% purchase of a target, acquisition of all of the capital stock of the target, merger, consolidation or reorganization). □ At a minimum, exclude deals that the buyer may complete in the ordinary course of business with the target.

FEES

Engagement letters can list an assortment of fees. Not all engagement letters contain all of the fees listed below. The amounts and timing of the payments are negotiable.

Fee	Advisor's Position	Buyer's Position
Retainer Fee	<ul style="list-style-type: none"> □ Seek a sufficient retainer to minimize risk of loss, particularly if the advisor is working with the buyer for the first time or if the transaction is small. □ Differentiate retainer fees from reimbursement of actual expenses. 	<ul style="list-style-type: none"> □ Insist that any fee paid to the advisor as a retainer be credited against later fees payable to the advisor. □ Try to keep the retainer amount limited (a cap), not open-ended, especially if payable on a periodic basis (such as monthly). □ Seek to have the retainer cover all or at least part of the advisor's non-out-of-pocket expenses (for example, incidentals like copying).
Agreement (Interim) Fee	<ul style="list-style-type: none"> □ Ask for early, partial payments on the occurrence of certain interim triggering events (such as finalizing a term sheet, signing a letter of intent or signing or announcing a definitive agreement) regardless of whether the transaction closes. 	<ul style="list-style-type: none"> □ Resist agreeing to pay any interim fee before a transaction closes or limit the fee to only one interim event. □ Reject payment triggering events that the buyer cannot control (such as any deal announcement that is not controlled by the buyer). □ Try to make the triggering event as close to the closing date as possible.
Transaction (Success) Fee	<ul style="list-style-type: none"> □ For large transactions, seek a transaction fee calculated as a percentage of the value of the transaction. □ For smaller transactions, seek a fixed fee covering the fee for services and non-third-party expenses. □ Define "transaction value" to capture all economic value that the buyer will receive (for example, assumed debt, collateral arrangements or agreements such as transitional service agreements, non-competition agreements, consulting agreements and other employment agreements). The parties often draft the definition as an annex to the engagement letter because the definition of "transaction value" determines the amount of the transaction fee. 	<ul style="list-style-type: none"> □ Seek a transaction fee structure that incentivizes the advisor to secure favorable economic terms (for example, an incentive fee for a lower purchase price). □ Define "transaction value" to cover only the actual acquisition cost and not any additional value that might be attributed to collateral arrangements such as guarantees, leases, transitional service agreements, non-competition agreements, consulting agreements and other employment agreements. □ Seek a fixed fee instead of a percentage when the value of the transaction is large. □ Negotiate a different formula for the fee if the result of the transaction is not equivalent to a 100% acquisition of the target. □ Insist that payment of any portion of the transaction fee based on contingent or future payments to the seller (for example, payments under an earn-out or contingent value right) be made only after the contingent events have occurred. □ Resist payment of any fees if the engagement is terminated for the advisor's breach or the advisor's unilateral termination of the engagement letter.

Fee	Advisor's Position	Buyer's Position
Termination Fee	<ul style="list-style-type: none"> □ Insist on payment of a “termination fee” based on a percentage of any break-up fee (or other similar fee) or reimbursement of expenses the buyer receives from the target. 	<ul style="list-style-type: none"> □ Agree to pay a termination fee only if the buyer actually receives a break-up fee (or other similar fee) from the target. □ Calculate the amount of the fee payable to the advisor on a net basis (deduct all costs the buyer incurs to collect money from the target and credit all prior fees paid to the advisor).
Expenses	<ul style="list-style-type: none"> □ Distinguish out-of-pocket expenses and third-party costs (such as travel and legal) from fees and request that these expenses and fees be paid periodically. □ Resist unreasonable caps on the amount of reimbursable expenses or limits on the types of expenses covered on smaller transactions where the fee may not be large. 	<ul style="list-style-type: none"> □ Limit expenses the advisor can claim reimbursement for, particularly if the transaction and transaction fee are large or try to have the expenses covered by fees. □ Define covered reimbursable expenses clearly and require that large expenses, all third-party expenses (such as outside legal counsel) and travel expenses be approved in advance.
Tail Period (see <i>Box, Glossary</i>)	<ul style="list-style-type: none"> □ Seek a long tail period (for example, 18 months to two years). □ Insist on a period that runs from whenever the buyer's last option to acquire a further interest expires. 	<ul style="list-style-type: none"> □ Try to keep the tail period short. □ Start the tail period from the date that the engagement terminates. □ Insist on no tail period if the engagement is terminated because of the advisor's breach.

ADDITIONAL PROVISIONS

Provision	Advisor's Position	Buyer's Position
Confidentiality	<ul style="list-style-type: none"> □ Carve out the advisor's unrelated departments (such as trading or capital markets) from confidentiality obligations (although the advisor will still be bound by non-disclosure obligations). □ Limit the duration of the confidentiality period as much as possible to eliminate risk that future actions of unrelated departments could be covered by the obligation. □ Require exceptions for: <ul style="list-style-type: none"> • publicly-available information and other information legally held by advisor; • disclosures required by law; and • retention of documents required by law or regulators. 	<ul style="list-style-type: none"> □ Limit the advisor's right to use or disclose information it receives about the buyer or the target for any purpose other than as provided in the engagement letter. □ Seek to bind the advisor to confidentiality provisions for at least one year after the end of the engagement regarding the buyer's information and to a period at least equal in length to the buyer's obligation to the target set forth in the buyer's confidentiality agreement with the target regarding the target's information. □ Ensure that any exceptions to confidentiality obligations are included in the confidentiality agreement between the buyer and the target. See if “back-to-back” agreements are possible. □ Be careful about broad standard exceptions.

Provision	Advisor's Position	Buyer's Position
Termination	<ul style="list-style-type: none"> <input type="checkbox"/> Ask the buyer to provide notice before the termination of the agreement. <input type="checkbox"/> Ensure that the buyer is obligated to pay fees that the advisor has already earned as of the termination date and fees from transactions introduced by the advisor and completed by the buyer during the tail period. 	<ul style="list-style-type: none"> <input type="checkbox"/> Insist on the right to terminate the agreement at will. <input type="checkbox"/> Ensure that the buyer is not obligated to pay fees if the engagement is terminated for the advisor's breach.
Exclusivity	<ul style="list-style-type: none"> <input type="checkbox"/> Have the buyer agree to engage the advisor as the buyer's exclusive financial advisor for the transaction or to pay the fees in full for transactions initiated by the advisor even if another advisor is also engaged. 	<ul style="list-style-type: none"> <input type="checkbox"/> Demand that the advisor not represent any other entity involved in the transaction or a related transaction.
Conflict of Interest	<ul style="list-style-type: none"> <input type="checkbox"/> Receive acknowledgement from the buyer and the target that persons outside of the advisory group are not covered and do not pose conflicts of interest that will limit them from providing their usual services. <input type="checkbox"/> Confirm that the advisor has no duty to the buyer to disclose non-public information about third parties or to have traders refrain from trading in the securities of the buyer or target. 	<ul style="list-style-type: none"> <input type="checkbox"/> Ask the advisor to disclose engagements of its other departments (such as trading, lending, investment management or capital markets) related to the transaction or the target. <input type="checkbox"/> Confirm that the advisor has Chinese walls in place to prevent dissemination of confidential information to non-advisor group persons.
Indemnification	<ul style="list-style-type: none"> <input type="checkbox"/> Insist on a separate indemnification agreement under which the buyer agrees to indemnify the advisor, its employees and affiliates for damages resulting from, or based on, the engagement or the transactions contemplated in the agreement. Indemnification should also cover any expenses incurred by the advisor in defending these claims. <input type="checkbox"/> Try to reject any indemnification cap. <input type="checkbox"/> Demand an indemnification obligation regardless of any court determination that indemnification is unavailable for reasons of public policy. 	<ul style="list-style-type: none"> <input type="checkbox"/> Carve out of indemnification obligation claims arising from the advisor's gross negligence or intentional bad faith acts. <input type="checkbox"/> Ask for a cap on the aggregate amount of damages payable under the indemnification provision or under any individual claim. <input type="checkbox"/> Insist that the advisor promptly notify the buyer of any claims and insist on the right to direct the defense of any claims for which the buyer may be required to indemnify the advisor.
Key Person	<ul style="list-style-type: none"> <input type="checkbox"/> Insist on an institutional engagement regardless of individuals or key persons continuing with the advisor. <input type="checkbox"/> At a minimum, agree in advance to a fee arrangement under which the advisor will receive a portion of the fees the buyer ultimately pays to another advisor if the advisor's engagement is terminated because a key person moves to another advisor. 	<ul style="list-style-type: none"> <input type="checkbox"/> If the buyer is retaining the advisor because of a key person, secure continued engagement of the key person and the right to terminate the engagement without fees except for a negotiated fee during a tail period for a target identified before the termination.

GLOSSARY OF TERMS

Term	Definition
Agreement (Interim) Fee	The fee a buyer agrees to pay its financial advisor when the buyer signs a definitive agreement or on the occurrence of another agreed-on triggering event such as the signing of a letter of intent, term sheet or announcement of a transaction, before a transaction closes. The amount of the fee is either fixed in the engagement letter or calculated based on a percentage of the transaction fee.
Financing Option	A financial advisor's option to finance the acquisition by a buyer it is advising or to arrange loans from other lenders so the buyer can complete a transaction. A financing option does not require the advisor to finance the transaction, but it either obligates the buyer to seek financing from the advisor before the buyer seeks financing from other sources (a right of first offer) or grants the advisor a right of first refusal to provide that financing if another lender offers to finance the transaction.
Key Person	A person with the financial advisor identified by the buyer as "key" in the buyer's decision to engage the financial advisor. If the key person leaves the financial advisor, the buyer wants to receive the right to terminate the engagement without further fees or a tail period.
Retainer Fee	The fee a buyer pays its financial advisor either at the outset of an engagement or periodically throughout the course of the engagement. These fees are non-refundable, but usually are credited against other fees payable to the advisor. Depending on how the provision is drafted, the retainer may also be drafted to cover some or all of the advisor's expenses.
Tail Period	The time period that begins after the advisor's engagement has ended and no transaction has been completed or at another time fixed by the engagement letter (such as on the expiration of a buyer's option to acquire a greater interest in a target). During the tail period, if a buyer completes a transaction with a party identified by the advisor, the buyer must pay the advisor a transaction fee.
Termination Fee	The fee a buyer pays its financial advisor when the buyer and a target sign a definitive agreement but the deal does not close and the buyer receives a payment from the target such as a break-up fee, topping fee (in a bankruptcy sale) or reimbursement of expenses. The termination fee is often calculated as a percentage of any payments the buyer receives from the target.
Transaction	The definition of "transaction" sets forth the circumstances under which the advisor will be paid its fees. Although an advisor may be engaged to identify a target with the objective of acquiring a 100% interest in the target (by tender offer, purchase of stock or assets or a merger), the actual deal may be something else such as a purchase of a minority interest, joint venture, installment purchases, options or collaboration or license of all material assets. The buyer and its advisor often negotiate the definition of transaction. The advisor prefers a broad definition so that it will be compensated for putting the parties together for any kind of deal. The buyer usually prefers that the advisor focus on its main objective, a 100% acquisition, and not be distracted looking for other kinds of deals.

Term	Definition
Transaction Fee	<p>The fee a buyer pays its financial advisor on the closing of a transaction. The fee is often calculated on a sliding scale based on the value of the transaction (for example, 1% of the transaction value for amounts up to and including \$100 million, plus 0.5% of the transaction value for amounts above \$100 million up to \$250 million, plus 0.25% of the transaction value in excess of \$250 million). If the value of the transaction is very large or very small, however, the parties may agree to a fixed fee. This fee is sometimes referred to as a success fee.</p>
Transaction Value	<p>The advisor's fee is based on the "transaction value" of the deal, whether it is a fixed fee or a percentage of the transaction value. The definition of transaction value is important to both the advisor and the buyer. The basic elements of the transaction value are:</p> <ul style="list-style-type: none"> □ The equity value (including all equity securities and amounts payable to holders of options, warrants and other derivative securities). □ The assumed long-term debt. <p>If the buyer contemplates contingent payments (such as earn-outs or contingent value rights), those payments would also be included in the definition of transaction value. However, any fees payable would arise only if the contingent payments are actually made. The definition of transaction value can also include, but far less frequently, the value of consulting agreements, agreements not to compete and so on.</p>

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