Engaging Investment Bankers in Sell-Side Transactions & Ensuring You Are on the Same Side of the Aisle

by Bryan S. Gadol, Partner, Dorsey & Whitney LLP

The mergers and acquisitions market is poised to see a dramatic increase in activity due to a variety of market indicators, including: the likely significant Federal tax rate increase on long-term capital gains, the level of excess cash reserves on corporate balance sheets, the extremely low interest rates, the pending expiration of significant capital commitments to private equity firms and the velocity and availability of debt financing on commercially reasonable terms. While not all sell side transactions require a seller to engage an investment bank to maximize enterprise value, the general rule is that a competitive process usually results in the highest price and the most favorable terms for a seller. Therefore, sellers that make the decision to hire an investment bank are well advised to go through a methodical selection process as the role of the investment bank (and specific deal team) is critical to the ultimate success of the transaction.

Once an investment bank is engaged by a seller, most would expect that their respective interests are aligned and both parties stand on the same side of the aisle with the unified goal to maximize value paid to the seller. However, in many cases the investment banking “form” engagement letter contains provisions that surprise sellers and result in the parties standing on different sides of the aisle on some key issues if such terms are not appropriately discussed and modified accordingly. In order to ensure a successful transaction, it is critical for sellers to have a meeting of the minds with the investment banking firm they select regarding the expected timing for the entire process, value expectations and the material terms of the investment banking engagement letter, including those described below. The purpose of this article is to discuss and highlight a few key issues regarding investment banking fees which arise in connection with engaging sell side investment bankers and which often surprise sellers. This article is not intended to be an exhaustive list of issues sellers should consider as part of the process.

Investment banking fees generally have three basic components: (i) retainer and expense reimbursement, (ii) closing payments, including minimum success fee thresholds, and (iii) post-closing payments for deferred consideration received by the seller related to escrows, holdbacks and earn-outs. Each component can vary dramatically depending upon the state of the deal market at the time of the selection process and the relative size of complexity of the proposed transaction. Therefore, sellers are well advised to meet with several reputable investment banking firms in the selection process in order to be able compare the proposed fee structures side by side.

Retainers & Expense Reimbursement. Retainers and expense reimbursement provisions are required by investment banks to simply cover general administrative expenses and are usually highly negotiable with respect to the total amount paid and the payment terms, with the retainer often divided into monthly installments. While sellers in many cases are surprised at the aggregate amount of the initial requested retainer, it is important for sellers to understand that the purpose of the retainer from the perspective of the investment bank is to not only cover some basic general and administrative expenses, but to help ensure the investment bank that the seller is in fact committed to the sale process. If the seller does not have any financial stake in the process, a seller is much more likely to abandon the sale because of a true lack of commitment to the process regardless of the potential outcome. It is also important for sellers to recognize that investment banking firms cannot survive on simply collecting retainers from clients without closing transactions and collecting their success fees. In the event the seller is
truly committed to the sale process with appropriate expectations on valuation, the significance of the retainer can be mitigated greatly by negotiating with the investment bank to credit the retainer paid against the closing success fee owed by the seller to the investment bank. If a seller is able to negotiate this provision, the payment of a retainer is truly a no-cost proposition if the seller consummates a transaction at the completion of the sale process.

**Closing and Post-Closing Success Fees.**

The first element a seller should consider when thinking about success fees is exactly what kind of a transaction a seller views to be a “success” worthy of paying a fee. Most form engagement letters require a closing success fee to be paid not only in connection with a “sale” of the company to a third party, but also in the event of a sale of the company to management or current equity holders of the company, the sale of a minority stake in the company, the license or lease of key assets or intellectual property and “similar transactions.” Therefore, it is critical for sellers to clearly communicate their objectives to the selected investment banking team and ensure that the definition of such transaction(s) which will require the seller to pay the investment bank a success fee is properly defined in the engagement letter.

The next element for sellers to consider in this regard is exactly what consideration received by the seller should be included in the calculation of the closing success fee. In addition to the actual cash and value of securities received by a seller at the closing of a transaction, most form engagement letters require debt repaid or assumed and the value of any assets excluded from the transaction to be included in the success fee calculation. In some cases, the success fee calculation in form engagement letters also includes cash that is distributed to the equity holders of a seller following the execution of the engagement letter as well as cash received by the seller at the closing of the transaction (which is simply a reimbursement to the seller by the buyer for excess cash on hand). Generally, investment banks agree to exclude such cash amounts from the success fee calculation, but careful attention to these provisions is important in the event the seller is currently operating with excess cash on hand or is projected to have excess cash on hand at the closing.

In addition to the amounts described above, form engagement letters also include in the fee calculation any amounts payable to any equity holder of the seller related to future employment or consulting services performed for the buyer (including any related equity compensation), to the extent such amounts exceed the “fair market value” of the services to be rendered or are paid in exchange for non-competition covenants by such equity holders of seller. From the investment banking firm’s perspective, including these amounts ensures that the seller is not incentivized to try and shift what would otherwise be viewed as purchase price consideration for the sale of the company into a post-closing employment/consulting arrangement with the buyer. Therefore, including provisions to capture these amounts are customary, but such provisions need to be carefully drafted to ensure they do not capture what is purely fair market value compensation for services rendered to the buyer following the closing.

Another key issue with respect to the success fee is to ensure a seller understands the division between closing consideration and post-closing consideration and the impact it has on determining the success fee payable to the investment bank at the closing. Specifically, most form engagement letters provide that any amounts held back by the buyer or placed in escrow by the buyer as collateral for certain matters, including the buyer’s indemnity protection, are included in the fee calculation for determining the success fee payable to the investment bank at the closing even though such amounts are not yet and may never actually be received by the seller. Holdback and escrow amounts
generally range from 5% to 20% of the total consideration and are generally held back or placed in escrow for a period of 12 to 24 months, but holdback/escrow amounts and the relative holding period vary dramatically based on the size and payment terms of a transaction. The investment bank will argue in many cases that such amounts should rightfully be included in the closing success fee calculation because the seller’s breach of a representation or warranty in the purchase agreement, which would result in a reduction of the holdback/escrow amounts, is solely within the seller’s control and the investment bank should not be penalized for an error or oversight by the seller. While in certain cases a breach of a representation or warranty is a result of a seller’s failure to properly disclose information at the time of entering into the purchase agreement, many seller breaches occur as a result of an unknown risk allocated to the seller in the purchase agreement that happens to materialize following the closing. In the event such a breach results in the reduction of a holdback/escrow amount to the seller, it is difficult to reasonably argue why the investment bank should also not participate in the loss of consideration. While certain investment banks may ultimately be unwilling to share this risk with the seller, it is important to understand the financial implications and negotiate with the prospective investment banks accordingly.

The most significant issue for sellers to watch for in connection with understanding what amounts are included in a success fee is the treatment of contingent consideration. Contingent consideration, also known as “earnout payments,” is a customary deal term to bridge expectation gaps between buyers and sellers and come in many different forms, but all fundamentally function to provide for additional purchase price to be paid to the seller in the event certain conditions (financial or otherwise) are satisfied following the closing. Surprisingly, many form investment banking engagement letters provide that these contingent payments or some portion of such contingent payments should be included in the calculation of the closing success fee. While reasonable minds can differ on the appropriate risk an investment bank should take with respect to holdback/escrow amounts as discussed above, it is completely inappropriate in most cases for an investment bank to receive any consideration at the closing for contingent amounts that may be paid to the seller until such time seller actually receives such amounts, if ever.

As evidenced from the above summary, there are a number of key issues which are commonly addressed in connection with engaging sell side investment bankers. In addition to the issues discussed above, additional key issues which warrant careful attention include: term and termination rights, tail periods, standards of care and indemnities, but such issues are beyond the scope of this article due to length restrictions from the publisher. Therefore, it is important for sellers to engage competent, experienced legal counsel during the investment banking selection process to ensure that the final engagement letter provides that both the seller and the investment bank stand on the same side of the aisle, with both parties being equally incentivized for the seller to receive the best financial outcome possible.

Bryan S. Gadol is a Partner in Dorsey & Whitney LLP’s Corporate Department and works out of the Orange County, California office. Mr. Gadol has extensive experience in mergers and acquisitions, joint ventures, public and private securities offerings, private equity and venture capital transactions. Mr. Gadol also provides general corporate and governance advice to emerging growth and middle market companies and investors operating or investing in a broad array of industries through all stages of the business and investment lifecycle.