Investment Banker Engagement Letters

By:Mary Beth Kerrigan
March 26, 2014

As companies begin the process of preparing for an acquisition, companies often engage an investment banker to assist with and facilitate the transaction. Companies should approach such an engagement as they would any other relationship with a third party service provider: companies should interview multiple bankers and perform appropriate due diligence on the bankers to ensure the chosen banker is the right fit. Often relationships with investment bankers develop informally over a period of time with initial meetings with investment bankers occurring several months (or even years) before a company is ready to formally move forward with an exit transaction.

As part of this process, at the appropriate time, a company will enter into an engagement letter with the selected investment banker. This engagement letter will cover many business terms which can vary depending upon the size of the transaction and other factors involved. Although not an exhaustive list, engagement letters will usually include the following terms, which should be carefully reviewed and negotiated by the company in consultation with its legal counsel:

1. Transactions Covered by Engagement. Typically, the term "Transaction" can be very broadly defined in engagement letters. Companies should ensure that the definition is appropriate and that the company will only be responsible for paying a banker fee on the relevant type of transaction. For example, bankers can be engaged to facilitate both a private placement/fundraising effort and/or an acquisition. Often there can be different fees associated with different types of transactions, all of which need to be carefully negotiated. A common definition of "Transaction" for an M&A event will include a transaction with any third party, even if the banker did not introduce the third party to the company or even if the company had a pre-existing relationship with the third party. In some instances, this approach can be appropriate. However, if a company has already established relationships with some potential acquirers, the company may consider changing the fee structure with the banker to accommodate a situation in which the banker is not required to spend as much time shopping the deal as otherwise anticipated. A revised fee structure could include a list of acquirers for which the banker would receive a reduced fee if the company closes a transaction with a third party on this pre-determined list.
2. Retainers. Investment bankers will typically request retainers – an upfront payment upon the signing of the engagement letter. Companies should ensure that any retainer will be deducted from the fee paid upon the closing of the transaction. Companies can also request that the retainer be paid over a period of months after the execution of the engagement letter. On occasion, bankers will waive these retainer fees; however, given the relatively small dollar amounts typically involved, there are often more important business terms to negotiate in an engagement letter. Depending upon the size of the transaction, retainers are often in the $10,000 per month range (or, if one lump fee, in the $50,000 range). If a company does agree to a monthly retainer, a company should consider capping the retainer in the event that the process takes longer than

anticipated.

3. Banker Fees. The fee to be paid to an investment banker upon the closing of the transaction can vary significantly. Bankers will often require a minimum fee and an additional fee based upon a percentage of the overall consideration paid to the company or its equity holders (often with a step approach – a certain percentage for a deal in a certain range, then an additional percentage if the consideration is higher – this approach can align the banker's interests with the company's interest). The percentage requested can vary significantly based upon the size of the transaction.
4. Escrows and Earn-outs. Bankers often request payment of the fee based on not just the amount paid at closing, but also any amounts to be placed in escrow or amounts in earn-outs that might be paid based on performance of the company after closing. For example, if the banker was receiving a 3% fee on a $100,000,000 transaction, one would anticipate that the fee would be $3,000,000. However, if the $100,000,000 consisted of $80,000,000 paid at closing, a $10,000,000 escrow and a $10,000,000 earn-out, the company could argue that the 3% fee should be based only upon the initial $80,000,000, thereby reducing the initial fee to $2,400,000. Thereafter, if the escrow is released, the banker would receive an additional $300,000 and if the earn-out is achieved, the banker would receive the remaining $300,000, each at the same time the equityholders of the company received such additional consideration. The rationale for this approach from the company's perspective is that if there is a claim on the escrow and/or if the earn-out is never achieved, then the true value of the company (on which the investment banker's fee should be determined), is the lower amount of $80,000,000. In essence, the banker therefore participates on a pro-rata basis with the equityholders with respect to amounts held in escrow and/or subject to an earn-out.
5. Tail Periods. Engagement letters with bankers will include a tail period – a period after the termination of the engagement letter during which if a transaction is closed, the banker still is paid its fee. This provision is often heavily negotiated and companies should try to limit this period to as short a time as possible, such as a 12 month period. These provisions should be read in conjunction with the termination provisions of the engagement letter. If the termination provision does not permit a company to terminate at any time (and instead has a minimum period of engagement), then the tail period can in effect be extended by the length of the engagement letter or the notice requirement period in the engagement letter. In addition, termination provisions often include language to protect companies if key employees leave the investment banking firm by stating that the company has the right to terminate the engagement letter without a tail period in the event such key employee or employees leave the firm.

In summary, companies should use care to ensure that the engagement letter signed with an investment banker is carefully reviewed, properly reflects appropriate business terms and does not have unintended business consequences.

For more information on this topic, please contact **Mary Beth Kerrigan**.

Check out our Investment Banker Engagement Letter video above!