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The Top Five Things You Should Know Before Signing An Investment Bank's Engagement Letter

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ABOUT THIS WHITE PAPER:

When you decide to work with an investment bank to sell your business, you will receive its customary form engagement letter. Much of what you see there is negotiable. Review this carefully before signing it, to make sure the terms are tailored to your situation. This article discusses five of the most important sections to consider.

Selling a business is often the most significant financial event in the seller's life. Most people will only do this once. That means they need guidance during the process. To help sellers maximize the value they receive for their company, we usually recommend they hire a reputable investment bank with experience in their industry.

After selecting an investment banking partner, you will receive its form engagement letter. Reviewing this letter closely and making smart decisions can increase your net purchase price. After 25 years in mergers and acquisitions, here are the five key areas I suggest sellers consider before they sign on the dotted line:

- The timing of fee payments—which should match when a seller receives money
- Defining the purchase price—so the success fee is accurately tied to the value received
- Indemnification provisions—protecting the investment bank in a fair way
- Reimbursing the bank's out-of-pocket expenses—but ensuring it's not unlimited
- Tail provisions—placing appropriate limits on the payments after the engagement ends

Five Key Areas A Seller Should Watch For and Negotiate

1. Timing of Fee Payments
2. Definition of "Purchase Price"
3. Indemnification Provisions
4. Reimbursement of Expenses
5. Tail Provisions

Negotiations Start Here

Investment bankers will tell you the engagement letter is their customary form. What you may not realize is that many of the provisions are negotiable. You should seek terms that best align with your situation and expectations.

You will likely focus on how the investment banker's fee is calculated. Sellers typically pay a success fee, calculated as a percentage of the purchase price. Sometimes you'll also see a small initial flat fee that would be credited against the success fee, or a minimum success fee. Be aware that other provisions will have a significant impact on the ultimate fee and important aspects of this relationship.

Here are five key areas a seller should watch for—and negotiate—in an investment bank's engagement letter.

#1: Timing of Fee Payments

In a simple transaction, the buyer will pay the entire purchase price in cash at closing. In most transactions, a portion of the purchase price is paid at closing, with the remainder post-closing (such as an escrow, an earnout, or seller financing). In these cases, the investment bank's engagement letter typically requires the percentage fee to be calculated and paid at *closing*. The fee often is based on the assumption that you will receive the maximum earnout and other payments.

Sellers usually can change this provision. You want the portion of the fee related to an earnout to be calculated and paid when the earnout is received. With some exceptions, fees related to the escrowed amount and the seller financing will be calculated and paid at closing—regardless of when or whether the escrowed amount and the seller financing are actually paid.

#2: Definition of "Purchase Price"

The engagement letter will define the purchase price in great detail. The investment bank wants to ensure the definition covers all types of potential payments, so everything will be included in its fee calculation.

Their definition of purchase price often includes these items:

1. The business's indebtedness
2. Compensation under post-closing employment contracts
3. Rent under leases with affiliates entered into at closing

Make certain indebtedness specifically excludes intercompany debt. Employment contracts should be purchase price only to the extent it exceeds fair compensation for the services rendered. The inclusion of rent may also be negotiable.

Engagement letters may ask that the fee be based on the implied value of 100% of the business—even if you're selling less than 100%. Carefully consider and negotiate these "implied value" provisions. They can mean a significant increase in the fee beyond the amount you expect.

#3: Indemnification Provisions
These provisions are a long, complicated mess of legalese. Bankers often present them as non-negotiable. But Freeborn has consistently succeeded in making a couple basic changes we believe are fair and reasonable.

For example, you should have the right to control the defense of any claim, because the indemnification provisions place the liability for claims on you. The investment bank also should not be permitted to settle a claim without your consent.

#4: Reimbursement of Expenses
Engagement letters customarily require sellers to reimburse the investment bank's out-of-pocket expenses when performing its services. This reimbursement is required whether or not a closing occurs. You may typically cap the amount of these expenses, or require prior approval for those beyond an agreed-upon amount.

#5: Tail Provisions
"Tail" provisions require that you pay fees to the investment bank even after the engagement letter has been terminated. The tail is designed to protect the bank against a seller who intentionally avoids a fee by delaying the transaction until after the termination date, or otherwise benefits from the banker's work without paying for it.

We have generally been able to limit the tail period to one year—and sometimes as little as six months—after the engagement letter ends. In addition, we typically have been able to limit the tail to only those buyers who were introduced to the seller during the term of the engagement.

Seller Beware

Several other issues are important to consider. They include termination provisions, the scope of the engagement, and a listing of the investment bank's principals involved with your company.

Start with making smart decisions on these five items. When you get them right, you make each party's obligations clear, avoid an ugly dispute over the fee, and ensure a smooth transition if you want to change investment banks. This leaves you free to focus on marketing the sale and choosing the best purchaser.

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