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Retaining Financial Advisors and Investment Bankers

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In our continually shifting business environment, many companies need to retain financial advisors/investment bankers in order to explore opportunities in restructuring, sale or merger, joint-venture and/or the issuance of securities.

The focus of this article is to discuss important legal and business issues which often arise in the negotiation and retention of financial advisors, which could influence the successful outcome of a proposed transaction.

This article will discuss (1) exclusivity, (2) the term of the engagement and "tail" periods, (3) transaction coverage, (4) compensation, costs and caps, and (5) indemnification.

Exclusivity and Non-Exclusivity

While many agreements explicitly recite that the advisor's engagement by the company is intended to be exclusive, other agreements are often silent on this issue. In many cases, however, the compensation provisions create a de facto exclusive agreement by requiring payment of a financial advisory fee upon a successful closing of a financial transaction with any person regardless of whether the financial advisor was involved in procuring that transaction. Since the business would have to pay duplicate financial advisory fees if it retains a second financial advisor, the agreement is for all practical purposes a de facto exclusive relationship. The intentions of the parties as to the exclusivity of the arrangement with the financial advisor can and should be discussed and clearly spelled out in the agreement.

A financial advisor will often argue successfully that exclusivity is necessary in order to avoid confusion in the marketplace from solicitations coming from competing financial intermediaries. Further, where a substantial effort is required to market the company in a sale engagement, the advisor may be reluctant to make a major investment of time and effort if it is at risk of being replaced by another advisor after the market interest has been created.

However, if a com–pany is considering selling only a small part of its businesses, or is only seeking a joint venture or an other form of strategic alliances with industry partners, a non-exclusive relationship may be more appropriate. In a typical non-exclusive arrangement, the financial advisor will earn its transaction fee only to the extent that it has been directly involved in arranging or introducing the successful transaction.

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On the other hand, certain exclusive arrangements sometimes eliminate or reduce fees with respect to transactions with certain prospective buyers or financial sources which were known or introduced by third parties before the financial advisor was retained. Under these circumstances, however, the advisor may be financially motivated to favor one buyer over another, notwithstanding the economic terms of competing offers.

Whether a financial advisor's agreement is intended to be exclusive or non-exclusive is an important term which should be carefully considered and clearly set forth in any retention agreement.

Terms and "Tails"

The term or duration of the advisory agreement is another important consideration. Generally, the term of the agreement depends on the nature and complexity of the engagement, but is often impacted by whether it is exclusive or non-exclusive.

Some of the variables to be considered in discussing the term of the agreement include: whether the company or other potential transaction parties are private or public (sometimes requiring stockholder proxy solicitation and approval); the size and complexity of the business; whether anti-trust filings are needed; whether an auction is being considered; and the timing and availability of audited financial statements. During the term, the advisory services are being provided and the company remains obligated for expenses and transaction fees upon consummation of a transaction.

Some agreements do not specify a designated period of engagement or an initial term. In such circumstances, the agreement often provides that either party can send a notice of termination on 30 days notice. While it is often argued that such termination provisions make an express term unnecessary, we generally advise against such approach. In the absence of an express term, where financial advisors simply become inactive and the parties do not formally terminate the relationship, clients may be confronted with claims for transaction fees long after active work on the engagement has ceased. To avoid any ambiguity, we believe it is usually preferable to have a designated term for any engagement.

The company generally prefers the term to be shorter in order to motivate the investment banker to move expeditiously and also to avoid longer disruption of its business. For example, a reasonable initial term for an engagement relating to the merger or sale of an operating business could range from six months to one year. Too short a period could hamper the process of identifying potential purchasers or fail to provide the time needed for due diligence by purchasers or their financing sources. A reasonable term usually meets all parties' interests. The period could be shorter where a selling company is a "full reporting" entity, has audited financials, and where most prospective purchasers are well known.

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Advisory engagements usually include a tail period following termination or expiration of the initial term of the agreement. During such tail period (which often ranges from six months to one year), the financial advisor often remains entitled to receive transaction fees, if a transaction is consummated.

Discussions of this tail provision often include not just the tail period length, but also the circumstances which trigger the financial advisor's right to a transaction fee.

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Financial advisors naturally prefer broad general terms tending to entitle them to a fee if any transaction is entered into during the tail period with any prospective purchaser. On the opposite side, sellers might argue that a fee is due only if a transaction is consummated during the tail period with a party identified during the initial term of the engagement.

Accordingly, the duration or term of a financial advisory agreement and any tail periods should be carefully considered in the context of the company's particular circumstances and objectives.

Transactions Covered

Another area for discussion is the nature and types of transactions included within the engagement. Financial advisors prefer broad general descriptions covering as many transactions as possible, such as sales and mergers, restructurings, joint ventures, equity or debt security issuances and financings, etc. Advisors argue that while the engagement may start out, for example, as the sale of the business, it may end up as something completely different—such as a joint venture or minority equity issuance. As noted below, the engagement often has separate fee arrangements for each type of transaction.

While the engagement broadly includes transactions on which a fee will be earned, it typically describes narrowly the actual services to be provided to those of "assisting the company" in the company's negotiations and solicitations, etc.

An operating company should carefully consider and precisely describe the various types of transactions included in the engagement. For example, businesses often form special purpose joint ventures and enter into routine financing transactions as part of their normal business operations. These routine transactions are usually not intended to be the basis for a transaction fee for the financial advisor and should be expressly excluded.

Compensation, Costs and Caps

Of great significance, and the subject of lengthy discussion, are the issues of compensation, costs and expenses payable to the financial advisor. A typical advisory engagement will include (i) a non-refundable retainer—often payable up front, (ii) a contingent transaction fee (it should be explicitly spelled out that this fee will be earned and become payable only upon consummation of a contemplated transaction), and (iii) an agreement to reimburse the reasonable out-of-pocket costs and expenses of such financial advisor.

The initial retainer is often justified as necessary for the advisor's up-front due diligence time and expenses. The financial advisor's primary source of compensation is generally in the form of a contingent "success" or transaction fee, since it is paid only if and when the transaction is completed. Since the engagement often covers numerous types of transactions, there are often several arrangements for compensation, tailored to the several possible types of restructuring transactions that could occur.

In a sale transaction, contingent compensation is often a percentage applied to the total "enterprise valuation" (as distinguished from the actual purchase price) of the business being sold or transferred. Over the inflationary years, the proverbial "Lehman Formula" (i.e., 5% of the first million dollars involved in the transaction; 4% of the second million; 3% of the third million; 2% of the fourth million; and 1% of everything above $4 million) lost its appeal in favor of higher percentages of the first few million of valuation followed by a higher percentage for values received in excess of such amount. Currently, financial advisory fees for a $50 million sale transaction can easily range from 3½% to 5% of the transaction value or triple the Lehman Formula.

There is often a minimum fee for a successfully consummated transaction, as well as various provisions regarding when such fees must be paid. In very large transactions, fee arrangements between investment bankers and companies usually involve much lower percentages and higher retainers.

In considering transaction fee formulas, companies should review the components of enterprise valuation, and whether it should include, for example, (i) salaries and compensation for non-competition arrangements created as part of the transaction, (ii) any or all outstanding indebtedness of the business, both long and short term (including working capital), and (iii) any contingent or "earn-out" consideration. Companies should also consider when the financial advisor's fees are to be paid. For example, whether a portion of the transaction fee is payable to the financial advisor before certain contingent consideration (on which it is based) is received. Additionally, some thought should be given to the various standards for valuing any non-cash consideration (including publicly and non-publicly traded securities) which may be received as consideration for the sale of a business.

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Many well-negotiated engagements reduce the contingent transaction fee by the amount of any non-refundable retainer and include reasonable caps on out-of-pocket expenses incurred by the financial advisor. It must be kept in mind, however, that unreasonable restrictions on out-of-pocket costs and expenses can be counterproductive for the seller, and could diminish the advisor's marketing efforts.

Whichever of the numerous approaches to the financial advisor's transaction fees is settled upon, most are best negotiated at the outset of the engagement. Careful understanding of the compensation formulas is critical to the successful retention of a financial advisor.

Indemnification and Contribution

It is customary in the financial advisory business for the party retaining the advisor to bear the financial risks of litigation associated with the transaction. Thus the financial advisor's engagement often has either a separate addendum or a substantial number of paragraphs devoted to indemnification, contribution and reimbursement of the financial advisor for any losses, claims or damages with respect to the engagement.

In our experience, business owners rarely spend the time and energy required to fully understand or negotiate the scope of their indemnification obligations (and related contribution provisions designed to protect the financial advisor if a court refuses to enforce the indemnification agreement). Over the last several years, these indemnification provisions have grown more complex and are generally designed to transfer any and all risks of potential litigation to business owners and away from the financial advisors.

One indemnification issue often discussed is whether such indemnification should exclude damages and claims or losses resulting from the financial advisor's own negligent, reckless or willful misconduct, or fraud. This provision is drafted to provide that the parties agree that the advisor has no liability unless there has been a final judicial determination that the advisor was grossly negligent, or committed willful misconduct or fraud. While hard to justify, many of these provisions have become a standard of the industry.

A contribution provision which is often overlooked may cap the obligation of the financial advisor to contribute to any losses to the actual amount of fees received by such financial advisor in any transaction.

More recently, there has been a trend to apply different standards of indemnification to claims asserted by (i) third parties, and (ii) the seller against its own financial advisor.

Notwithstanding the customary practice in the industry to allocate most of the risk to the business owners, there is often room for negotiation in several areas, including notice, cooperation and legal cost control, which are of benefit to business owners.

Conclusion

The execution of a financial advisory engagement is often the first, and very significant, step in a transaction which will have a major impact on a company and/or its selling shareholders. Companies need to consult experienced counsel and to carefully consider all of the terms of such engagements, including those discussed above before entering into a retention agreement.

It is also important to fully define the scope of the obligations among the parties in any financial advisory engagement. For example, many financial advisors take the position that they are not fiduciaries in relation to the client being represented. Accordingly, a company should consider the possibility of its former financial advisor representing the other side in a non-friendly transaction or a competitor, while such company's confidential business information remains with such financial advisor.

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