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**M&A Engagement Letters: Don’t get stung by the success fee**

You’ve decided to sell your company, and you’ve engaged a financial advisor to find a buyer. The financial advisor sends you its standard form of engagement letter, and you sign it. Agreeing to pay the financial advisor a commission based on the sales price seemed reasonable at the time.

The engagement letter contains the following provisions (based on an actual engagement letter):

“**Success Fee:** If, during the term of this agreement, the Company consummates a sale of stock or assets, the Company agrees to pay financial advisor in cash at the closing a success fee in the amount of $225,000 plus three percent (3.0%) of the Selling Price.

“Selling Price” means the sum of the fair market value of any consideration received by the Company and/or its owners including:

(a) Cash, notes and/or other securities from the purchaser, plus

(b) The fair market value as of the closing of any assets including cash, other working capital and any other assets, less liabilities retained by the Company or distributed to its owners, plus

(c) Any interest-bearing debt of the Company as of the closing that is assumed by the purchaser or is satisfied by the Company and/or its owners as of the closing; plus

(d) Any contingent payments, noncompete agreements, consulting agreements, employment contracts and other forms of remuneration associated with the transaction received by any of the owners of the Company.”

**Congratulations, We’ve Got a Deal!**

A buyer for your company is found and a deal is consummated! The agreement calls for the purchase and sale of all of the outstanding stock of your company for an aggregate purchase price of up to $15 million, consisting of $10 million paid on the closing date and $5 million in the form of an earn-out (i.e., payment is contingent on the achievement of certain financial milestones after the closing).
• Of the $10 million payable at closing, $5 million is payable in cash and $5 million is payable pursuant to a five-year promissory note.

• Of the $5 million of cash payable at closing, $1.5 million is deposited into an escrow account to be used to satisfy the sellers’ indemnification obligations.

• The agreement requires the company to have at least $1.5 million of working capital on the closing date and requires the sellers to pay off a $1 million outstanding line of credit.

• You and the other three owners of the company are each given an employment contract by the buyer that provides for a base salary of $250,000 per year.

The success fee is due and payable at closing

At the closing, the financial advisor determines the Selling Price to be $18.5 million, consisting of:

• $15 million (the cash deemed to be received by the sellers at the closing plus the principal amount of the seller note); plus

• $1.5 million (working capital required at closing); plus

• $1.0 million (line of credit paid off at closing by the sellers); plus

• $1.0 million (the deemed value of the employment contracts to the four sellers).

Accordingly, at closing the financial advisor receives $225,000 plus three percent of $18.5 million, for a total success fee of $780,000.

Unfortunately, things don’t work out as anticipated

As it turns out, the buyer was in over its head and didn’t understand your industry. It files for bankruptcy and defaults on the $5 million seller note. Before filing for bankruptcy, however, the buyer is successful in obtaining indemnification payments for the full escrow amount of $1.5 million. Needless to say, the earn-out milestones are not achieved, so neither you nor the other sellers receive any of the $5 million earn-out. In the end, you paid a success fee based on a “Selling Price” of $18.5 million but only received $2.5 million after paying off the $1 million line of credit. (You shake your head at the concept of paying a commission on debt that you pay off. That’s just crazy, you think.)

Had you paid a success fee based on what you and the other sellers actually received, it would only have amounted to $300,000. In hindsight, you overpaid the financial advisor by $480,000, or 160%. You’ve been stung by the success fee.
How to avoid being stung by the success fee

As this example illustrates, it is critical to get advice from experienced counsel before you engage a financial advisor for the sale of your business. To avoid being stung by a success fee in an M&A engagement letter:

- Don’t sign any engagement letter until you’ve had it reviewed by your legal counsel and you’ve had an opportunity to discuss its terms with your counsel.
- Limit any success fees based on an earn-out to earn-out amounts actually received;
- Don’t include assumed debt in the definition of sales price upon which the success fee is based (after all, the assumption of the debt was factored into the purchase price);
- Don’t agree to pay a commission on debt you pay off;
- Exclude ancillary items from the definition of sales price, such as payments for consulting or employment agreements (after all, you need to perform services to receive those payments);
- Only pay a success fee based on amounts in an escrow account if you actually receive those amounts;
- Ensure the success fee structure incentivizes the financial advisor to secure the most favorable economic terms (such as by using a progressive fee structure where the fee percentage increases the higher the sales price); and
- Ensure the minimum fee, if any, is not structured to disincentivize the financial advisor from seeking the best price for the transaction.

We’re here to help. Please contact Iain Mickle or any other member of the Boutin Jones Corporate and Securities Group if you have any questions regarding this article.

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