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This article was written by Russell Robb, editor of M&A Today and an experienced middle market intermediary. It appeared in an issue of M& A Today and we think an excellent introduction to the world of the middle market. After all, after prospecting for clients, the next and very important step is finalizing the engagement agreement or contract. In the world of general business brokerage it is referred to as the listing agreement. Whether you intend to work in the middle market, add it to your business – or are just curious, you will learn from the following article.

Negotiating Contracts Between Intermediaries and Clients

Overview

Most M&A contracts with Intermediaries and their clients appear to be innocuous, but often the devil is in the details. We will address these details and show why they should be carefully considered before "carte blanche" acceptance.

As a general observation, beware of Intermediaries who have very lengthy engagement letters, e.g., over four pages long, and conversely beware of a potential client and/or the client's attorney that attempts to significantly rewrite the document. It is highly recommended that the Intermediary spend the time to verbally go over the agreement before mailing or dropping it on the lap of the potential client as he walks out the door. While we will discuss the details of Intermediaries contracts and their ramifications, it should be noted that *M&A Today* considers the six most critical components ad the following items:

- Time Period
- Retainer Requirement
- Compensation Methodology
- Minimum Fee
- Exclusivity
- Tail on Identified Targets

<u>Components of the Contract</u>

Time Period – A general non-exclusive agreement not subject to retainer payments can run indefinitely until terminated by either party; however, most jurisdictions require that such agreements require a specific expiration date. Agreements which are based on retainer(s) normally run between non-cancelable periods ranging from three months to 12 months and sometimes 24 months. Probably the former is too short and the latter is too long. If the relationship is not working, it is better for both parties to agree to disagree, so *M&A Today* would recommend a six month minimum.

Retainer Requirement

Within the scope of this article, *M&A Today* is unable to fully address this component of the contract. The size of the retainers in the middle market might vary from a low of several thousand dollars to $100,000 and might be charged as a one-time upfront flat fee or levied on a monthly basis. Most Intermediaries credit back all or most of the retainers toward the success fee. As a potential client, beware of Intermediaries who charge too little as well as too much. Whatever the amount, the client should monitor and measure the Intermediaries results on a monthly basis.

Compensation Methodology

In a survey regarding Intermediaries conducted with primarily middle market situations with members of the Association for Corporate Growth by Diane Harris of Hypotenuse Enterprises of Rochester, New York, the results showed the following: Standard Lehman (32%); Modified Lehman (25%); Negotiated (43%). Further on in this article, we show how a negotiated incentivized compensation package might be structured.

Minimum Fee

This component is an extremely important fee for the Intermediary to protect himself on the downside. For example, let's suppose a buyer carves-up the balance sheet, leases the equipment, rents the real estate, takes out the cash and accounts receivables so there is no working capital. The actual purchase price might be vastly reduced, but the seller's remuneration after the deal settles is very advantageous. The Intermediary should adjust the minimum fee up or down depending on each individual proposal and not just plug in a standard number for all transactions. In the Hypotenuse survey, the average minimum success was around $150,000.

Exclusivity

Occasionally, a selling client will bring forward a name or two of potential buyers with which they have had previous contact. Either the sellers want to exclude these names or suggest that there be a discount on the fee if a transaction takes place. Such a practice is an untenable situation because the Intermediary loses control of the assignment. Perhaps the worst case for which *M&A Today* is aware happened with the sale of a company in which the CEO owned 60% of the company and the sub-contractor owned 40%. The two owners convinced the Intermediary that there was no way the 40% owner was interested in buying out the majority owner. Six months later, the Intermediary received an acceptable offer for the business, but by then the 40% owner decided to match the offer and acquired 100% of the company. Unfortunately, the Intermediary had foolishly written an exception, so it was not an exclusive contract.

On the buy side, exclusivity is more difficult to control. It boils down to whether the Intermediary or the potential client is in the driver's seat. In the same survey by Hypotenuse Enterprises mentioned above, nearly 50% of the Intermediaries on the buy-side have agreements that are either non-exclusive or the agreement is silent on that subject.

Tail on Identified Targets

Another seemingly unimportant component in the contract, is the tail, because it can haunt those Intermediaries who do not believe that busted deals, nor rejected target companies have a way to be revived. The tail is defined as the period after which the term expires but a fee would still be paid to the Intermediary if a transaction is completed. The tail should be three years after the target has been

identified in writing. Some potential clients want a one-year tail and will easily settle for 18 months; however, the common compromising period is two years. One Intermediary had the unfortunate experience of losing a $50,000 commission, because the tail was only one year. After spending six months contacting 60 venture capital firms in order to raise one million dollars, he finally received a commitment from one firm. Although the money was forthcoming, the company desperately needed the money immediately to meet orders in hand and took a short-term bridge loan from a finance company. A year later, the venture capitalist invested one million dollars and left the Intermediary out in the cold empty-handed.

Other Issues

Collection of fees

If the middle market selling company is weak financially, the Intermediary can be jeopardized in collecting his accomplishment fee because there may not be money left over at closing. Therefore, the Intermediary who senses such a possible short-fall, should insist on a personal signature on the contract by the owner(s) as well as a corporate signature.

A non-M&A transaction

While not the original objective, some M&A assignments end up in a joint venture, a royalty agreement, an alliance, etc. If worded correctly, and the client's attorneys do not take umbrage that the "minimum fee" covers such transactions, then the Intermediary might be properly covered. On the other hand, an additional paragraph in the contract such as the following might be more appropriate: "If, as a result of Intermediary bringing a company to your attention in writing, you enter into a license, patent, know-how, process marketing, production, joint venture or other similar agreement (Contract) not involving a Transaction with any individual(s) or partnership(s), company(ies), or corporation(s) resulting from contact with that company while this Agreement is in effect, such Contract shall not be subject to the compensation provisions set forth in Section XX above, but you shall pay Intermediary one percent (1%) of the net sales (Gross sales less returns and allowances) of the products or services covered by the Contract or ten percent (10%) of the royalty or license fee payable to your company, whichever is greater. Amount due Intermediary will be paid quarterly, or for the term of the Contract or successor Contracts, whichever is less, provided that a Contract in respect to this Transaction continues to be in effect."

Broker/Dealer Problems

There have been numerous occasions after a deal is completed where the client has challenged the Intermediary as not being properly registered as a broker/dealer and therefore not qualified to receive the investment banking fees. The "sticky-wicket" appears when an Intermediary sells the stock, not assets, of a public company. While this publication is not able to properly cover the complexities of this issue in this edition, it might be prudent for Intermediaries who are not broker/dealers to insert a disclaimer in the contract such as the following:

"XYZ Company acknowledges that Intermediary is not a broker/dealer and will not be performing the services of a broker/dealer. Intermediary shall act only as a consultant and advisor to XYZ Company with respect to Service(s) as described herein, and is not, nor will it represent itself as, a broker, agent or employee of XYZ Company. Intermediary's not acting as a broker/dealer shall not be reason for XYZ Company to withhold any Fee(s) that would otherwise be due to Intermediary."

The Real Estate Factor

With some companies, like retail chains, the greatest value is the real estate which is often leased to the buyer, not sold. An Intermediary should incorporate a phrase in the contract which will allow him to receive a commission on the rentals in case the real estate is not sold outright. Real estate transactions, if separated from the entire transaction, will require the Intermediary to have a real estate broker license. Commercial realtors utilize the following commission schedule for rentals:

Rate	Year
5.0%	1
4.0%	2
4.0%	3
3.0%	4
2.0%	5
1.5%	Over 5 years

Break-up Fees

Fortune 500 companies incorporate break-up fees in almost all of their anticipated transactions, but to our knowledge, it is hardly ever incorporated in middle market agreements. In large Fortune 500 deals, a 1% break-up fee on a $1 billion deal is $10 million, or an amount to get someone's attention. As a matter of record, Mergerstat recently reported the average break-up fee for public companies is now over 3.5% of total invested capital in the deal up from an average of 2.5% in 1997.

In a standard real estate agreement, for example, if the house is listed for a million dollars, and a broker brings a bonafide offer for the same amount … and the home owner refuses to complete the deal, the broker is entitled to his full fee. For corporations, it is a little tricky because the terms of the offer may not be 100% cash at closing.

Nevertheless, *M&A Today* expects more break-up fees will be incorporated into middle market deals, because we have seen a few situations whereby the buyer met the seller's expectations. In such situations, the break-up was the minimum fee compensation, not the full Lehman fee. Maybe an agreement of this type needs to be qualified with an offer that has at least 80% cash at closing.

Indemnification

A legalese statement is always preferred in contracts, which in essence states that the Intermediary is not responsible for the accuracy of the financial statements nor the representations by management.

Fee Calculation

It is extremely important to include how the fee is to be calculated. Let's suppose the buyer acquirers "the stock" of the company for one million dollars with a book value of one million dollars and interest bearing debt of three million. Is the commission based on one million dollars or based on four million dollars, i.e., the assumption of equity and debt? The answer is the latter, but it is advisable to spell out this calculation.

A particular "sticky-wicket" is how the Intermediary will be compensated for contingent payments, e.g., consulting and non-compete agreements, earnouts, notes, etc. It is best to state some methodology such as discount the expected amount and discount the payment at closing based on a present value computation.

The more common method but more difficult to administer, is for the Intermediary to be paid when the seller is paid.

Dispute Resolution

Most Intermediaries who include this item in their contract specify the jurisdiction (their state) and comment that arbitration, the method of resolution, is binding.
Hypotenuse's survey indicates 10% of transactions lead to disputes between the Intermediary and their client…usually regarding the amount of the fee. Of these disputes, about 10% end up in a lawsuit which computes to 1% of all transactions ending up in a lawsuit. Most of these disputes are settled through negotiation of both parties.

Incentivized Compensation

If an Intermediary is to use an incentivized fee arrangement, the monetary upside should be substantial in order to account for the inherent risk of not receiving the normal commission on a base case sales price. Let us assume that management of the selling company challenges the Intermediary to revise their accomplishment fee to an incentivized fee based on achieving a higher sales price.

Considerations

Several years ago I was making a presentation to a Board of Directors in the expectation of representing their company for sale. One of the directors asked if the Lehman formula success fee was negotiable. I responded: "Absolutely not," thinking that that was the "sacred cow" of the agreement. After the meeting I was told very bluntly by the same director: "Don't ever say nothing is non-negotiable." Needless-to-say, I did not get the assignment. In hindsight, I should have listened to the Board's counter proposal, but of course, counter with a higher minimum fee or not deduct retainers from the accomplishment fee, etc. Never give up something in a contract without countering with something in return.

Another consideration is whether the Intermediary should stick to their contract on the basis that they do not have to "wheel and deal" particularly if they specialize in a certain industry. *M&A Today* has been told by those Intermediaries who do specialize that if word got out amongst the close knit industry that the Intermediary was, "cutting different deals" for different folks that eventually their reputation would be jeopardized.

In my experience as an Intermediary, many clients do not ask the right questions, nor really know what to expect from an Intermediary. I remember fifteen years ago when I had just entered the M&A business, I quoted a potential client a $4,000 monthly retainer. When I realized that I should have quoted $5,000 per month, I went back to my contact and told him that I had made a mistake. Unphased by my remark, he wisely asked: "How much of your time am I going to get on a monthly basis and what should I expect to receive in terms of deal flow?" Now we have a client that begins to understand the Intermediary's business!

And finally, as an Intermediary, if you are going to make compromises to an engagement letter with a client, slow down and think about it for a day or two and consult your partners before you respond. For a potential client to ask for approval of certain changes in the agreement in the next 24 hours sounds innocuous. Most Intermediaries take nine months or more to complete a deal, so do not rush the

agreement process. Take time to pragmatically think through the ramifications of any changes in the agreement.

Conclusion

M&A Today has discussed various aspects of Intermediaries' contracts with their clients. In summary, be absolutely clear to communicate the Intermediary's agreement, preferably by giving examples: a 2% fee on a $25 million transaction equates to a $500,000 fee to the Intermediary. Some buyers want to renegotiate the contract during the letter of intent stage, because all of a sudden they realize that in the case described above, 2% equates to half a million dollar fee. Intermediaries should not compromise on their fee just because the amount appears to be so large…just think of all the failed deals in which the Intermediary was not rewarded.

In my opinion, it is a mistake for the client to squeeze the Intermediary financially to the extent that they lose much of their incentive. Instead, clients should focus on how best to work with Intermediaries in order to bring out the best of their talents and resources. Conversely, Intermediaries by virtue of being retained by clients are expected to produce quality deal-flow for either their buyer or seller client. By working together with equal respect, the Intermediaries and their client can succeed. Their contract may be the foundation of their working relationship, but their mutual good faith and respect for each other will ultimately be more important.

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