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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives. Acredula is available to clients and friends of the firm. It is not to be construed as legal advice or opinion.

Right of Reliance on Investment Bankers

We anticipate the focus of corporate America will shift over the ensuing months from self-evaluating internal controls and other governance matters to acquiring and disposing of assets. This issue of *Acredula* contains two articles by Mike Sullivan, our most experienced lawyer in asset acquisitions and dispositions. The first deals with choosing an investment banker to help with these matters. The second gives, in question form, seven pointers in negotiating the engagement letter with the investment banker.

Corporate law contemplates, by providing that all authority of a corporation not reserved to shareholders is to be exercised under the direction of its directors, that boards will delegate. Moreover, directors have a statutory right of reliance on information, opinions, reports or statements prepared by investment bankers and other professionals as to matters that the directors reasonably believe are within the person's professional or expert competence. This right of reliance applies both to directors of the board as well as to directors of any committee. So that directors of the board who may not be directors of an applicable committee can also rely upon an expert reporting to a com-

mittee, directors also have a statutory right of reliance on any information, opinions, reports or statements prepared by or for a committee as to matters within the committee's designated authority which the directors reasonably believe merits confidence.



EDITOR'S NOTE

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This right of reliance is one of the major protections of a board against liability in suits from shareholders, members, creditors, and even regulators. The right protects not only directors of publicly held

companies against potential claims of creditors, shareholders and regulators like the SEC, but also privately held companies against the same claimants as well as non-profit or tax-exempt organizations against potential claims of creditors, members, state attorneys general, and regulators like the IRS.

However, to be entitled to the statutory right of reliance on an investment banker, the director or committee must have a reasonable belief that the matter relied upon is within the professional or expert competence of the investment banker. Courts generally judge this by viewing the

“process” of directors in selecting the investment banker, instructing the investment banker for his/her services, and receiving the investment banker’s report. Courts are more likely to find a director’s or committee’s belief reasonable if (i) the director or committee was involved in the selection of the investment banker and preparation of the engagement letter instructing the investment banker, and (ii) the report of the investment banker is received in a discussion among the director or committee

and the investment banker rather than in a monolog presented by the investment banker.

Finally, although the investment banker should be hired to advise and provide services to both the board as well as management, the investment banker should be hired by and ultimately be subject to the direction of the board or a board committee authorized to do so in the same way that the outside auditor is hired by and subject to the direction of the board or audit committee.

Choosing an Investment Banker— Some Practical Pointers



By
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An important trend in corporate governance in recent years has been the increasing use of investment bankers outside the traditional arena of securing debt and equity financing. Investment bankers are increasingly asked to represent companies in the purchase or sale of businesses and to provide research and opinions regarding the fairness of transactions to the shareholders of a transaction participant, particularly when management has a relationship to another party to the transaction. This trend has been reinforced by court decisions in which directors’ reliance on the opinion of outside experts has been a strong shield in defense of breach of fiduciary duty claims. This article will identify issues to which the board of directors should be sensitive in making important decisions regarding investment banker representation.

Who Makes the Selection?

An important consideration in addressing this issue is the purpose for which the investment banker is being used. Where no conflict-of-interest issues are presented, management is the likely source for recommendations to the board, just as it would be when the corporation retains other professional advisors. However, in a situation where a special committee has been chosen because certain board members or

members of management have a conflict of interest, it is important that the fingerprints of the conflicted parties not be all over the selection process. In a disputed transaction, the reasonableness of the board’s reliance on the opinions of experts will be subjected to every conceivable challenge. Basing a selection on a recommendation, or abandoning a selection based on a veto power, of conflicted management unnecessarily diminishes the effectiveness of the expert opinion to be rendered.

Selecting the Field of Candidates and Culling the List

Size/Cost

Generally, these two characteristics go together. A major New York investment banking firm may charge many times the fee that a regional investment banking firm would charge for a fairness opinion. In turn, that regional investment banker may charge many times the fee that a local investment banker would charge for preparation of the same opinion. While acquisition fees may not range as widely, typically, the larger investment banking houses will charge a higher minimum fee. In a bet-the-company transaction involving a large publicly held company, the contacts and resources of the major investment banking firm may be exactly what is

needed. In other situations, such selection may fall in the category of buying a Rolls Royce for a trip to the grocery store.

Industry Specialization

Whether looking for a business disposition, a business purchase or a fairness opinion, the investment banker's familiarity with your industry can be crucial. Knowing the players, the details of recent transactions and quirks of valuation can be crucial for a board seeking to reach a sound and defensible decision. Many of the largest investment banking firms have a wide range of highly expert industry coverage. Due diligence on smaller firms may reveal some that are giants in one or a few particular industries.

The Selection Process

The best method for making a final selection of an investment banker for a major project is through an interview process. Such a process serves to establish the reasonable belief of the directors making the selection that their expert is reliable and competent in the matters delegated—a prerequisite for director reliance on opinions which may be given. Additionally, these are very bright professionals who sell their services by identifying issues and opportunities; and a one-hour conversation with someone doing deals in the industry on a daily basis can be a terrific educational opportunity.

If confidentiality is a concern, and it almost always is, the board should consider having its outside counsel make initial contacts with investment bankers. On rare occasions, an investment banker's need to demonstrate cutting-edge knowledge of what is happening in the industry results in a losing competitor spilling the beans at an industry gathering. This is an unavoidable risk which dictates that proposed investment bankers be pre-screened to the extent possible and interviews kept to a reasonable number. Outside counsel can be helpful by doing pre screening on a blind basis regarding ranges of potential cost and potential conflicts of interest. Ad-

ditionally, counsel can frequently secure from the investment banker a signed confidentiality agreement prior to identifying the prospective client.

In the interview, the board should, at a minimum, cover the following issues:

1. Scope of engagement. What will the investment banker provide and what will it expect the company to provide to it? What will the ultimate work product be?
2. An estimate of the engagement's cost. If the cost appears prohibitive, how can the engagement be recast (e.g., by providing due diligence guidelines and industry comparables instead of a formal fairness opinion)?
3. A detailed conflict of interest review of the investment banker's past relationships with the other party to the transaction, conflicted directors and businesses with which they are affiliated.
4. Industry expertise of not only the investment banking firm, but the specific individuals who will be charged with responsibility for the representation.
5. Timelines for producing a work product.

The corporation should retain in its files written materials presented to the directors by each of the investment bankers and a website address for each. This will create a trail of evidence as to the care and diligence which went into the selection.

Conclusion

Your choice of investment banker can result in greatly enhanced shareholder values and avoidance of costly and unproductive litigation. It can also result in a pure waste of time and money. Attention to the selection process will be a prime determinant of which of these consequences results.

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Investment Banker Engagement Letters: Seven Questions to Ask Yourself Before You Sign

An investment banker (“IB”) can be an absolutely crucial team member for a company considering the purchase or sale of a business or a transaction with an affiliated party, which might be challenged on fairness grounds. Many companies seeking to form such a relationship are unfamiliar with what components of the investment banker/client relationship are standard and what components can and should be negotiated. The questions below highlight aspects of the relationship that are highly negotiable and that are of significant interest to management:

1. What is the specific job I want accomplished?

Like other service purveyors, IBs offer a wide menu of services, each with a price tag attached. If you are looking for valuations for internal purposes, you may not want an expensive written opinion. If your principal goal is to reduce the potential of successful litigation based on a fairness challenge, you will want to pin down details of the fairness opinion you are requesting, the ability to publish that opinion to the outside world and the availability of the IB to defend and explain that opinion in a later court challenge. If you wish to determine the advisability of selling your business versus refinancing but have internal resources capable of structuring refinancing, you will want to be sure that this latter duty is not included in the IB’s scope of engagement.

Occasionally, an IB will seek a commitment that engagement for a particular project will carry over into a guaranteed engagement for future financings or other investment banking services.

Generally, these requests are negotiable and can be successfully resisted with the argument that return business would automatically occur if the IB has performed well.

2. Do I have a detailed understanding of the fee and does it set up the incentives I want to establish?

While IBs of similar size and stature may charge fees which are comparable, comparative pricing is advisable and negotiation of payment formulas is not uncommon. For example, it is common to compensate IBs based on a formula when they assist in finding a purchaser for a company. A typical “Lehman Scale” compensation formula would provide for a fee of five percent of the first \$1 million of purchase price, four percent of the next \$1 million, three percent of the next \$1 million, etc. This formula recognizes that the up-front work in obtaining any offer is substantial and should be compensated out of the base purchase price. However, it encourages the IB to close a transaction quickly rather than to push for the highest possible price. A fee formula with the highest percentage payments at the highest end of the price range might be both negotiable and advisable.

Once a fee formula is established, the negotiation work begins. Let us take the Lehman

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Scale fee referenced above. Simple enough? It would appear so. However, it created a temptation for clients to move purchase price dollars into post-acquisition salary-payment dollars or other non-commissionable items. In response, IBs began defining the base against which fees would be assessed more and more broadly, to include various classes of assumed liabilities and future payments, which might have very little to do with a client's perception of the value received in the sale of the business. Accordingly, these provisions must be heavily negotiated to create a fair result for both sides. As a starting point, a prospective IB should be asked to give a pro forma estimate of the fees by applying the formula proposed in the engagement letter to the financial profile of the client.

3. Does the engagement letter contain provisions that protect my right to rely on the IB as an independent party?

One of the decisive factors in selecting an IB to advise on a transaction is the independence of the IB from parties with adverse interests. More frequently than not, however, engagement letters fail to require that the IB maintain this independence after beginning the engagement. Unless you want the unhappy surprise of finding that your IB has just closed a deal to advise your potential purchaser on its next four acquisitions, the engagement letter should address this.

4. Have I taken steps to ensure the confidentiality of sensitive information imparted to the IB?

Perhaps the most important time to obtain a confidentiality covenant is before the company has been identified to a prospective IB. It is also true that substantially all IBs have set

up barriers between their investment advising staff and brokerage staff, so that confidential information derived from their investment banking analysis cannot be used for illegal insider trading. However, reasonable restrictions on the IB's utilization of information derived from the company are entirely appropriate in the engagement letter. In the unlikely event the IB's confidentiality systems are breached, the company and its management will benefit greatly if they can show that the engagement letter includes confidentiality restrictions designed to protect the intellectual property of the company and prevent insider trading.

5. Do the indemnification provisions provide the IB with too much protection for an incompetent work product?

To some clients it seems that after arguing for an astronomical fee for risks to be incurred, the IB then lays off all of those risks back on the client with indemnification provisions. Indemnification, unfortunately, comes with the territory; and it does serve some purpose in protecting the independence of IBs in the case of threats by strident corporate gadflies or persons trying to deep-six a transaction for their own purposes. However, indemnification should be subject to reasonable limits, especially regarding standards of care and control by the indemnifying party of the litigation and any settlement.

6. Does the timing of the fee payment potentially result in my company paying for results that are not provided or services that are not wanted?

Most investment banking services result in the completion of a transaction. Most risks undertaken by IBs result from the rendering of an opinion with respect to a transaction that is consummated based on the opinion. The timing of fee payments should reflect these facts. An initial payment should reflect the IB's costs of

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gearing up for due diligence activities and its lost-opportunity costs. When opinions are rendered, the fee payment should reflect the effort that went into the opinion and the risk being assumed by issuance of the opinion. When the transaction closes, the fee should reflect the benefit to the client and the enhanced risk to the IB. In this regard, clients should be wary of fees based on receipt of an offer, payable even though a closing does not occur. A fee payment too heavily weighted to the front end can result in an unfair result to the client.

Beware of an open-ended investment banking relationship that, e.g., provides for payment of a fee in the event of any sale of the client's business during the next X months or years. It is reasonable to expect compensation if a prospect discovered and introduced by the IB ultimately purchases the company, and a grant of exclusivity for a reasonable time period is appropriate. However, a client should not be saddled with multiple IB fees or foreclosed from the market for an extended time because, e.g., his initial IB proved incompetent. Neither should the IB be able to submit a "telephone book" of potential prospects and thereby generate a fee based on a successor IB's efforts.

7. Does the termination provision of the engagement letter unfairly penalize me if a transaction does not work out?

The right answer to these questions will establish a firm foundation for an important and beneficial relationship for your company.

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