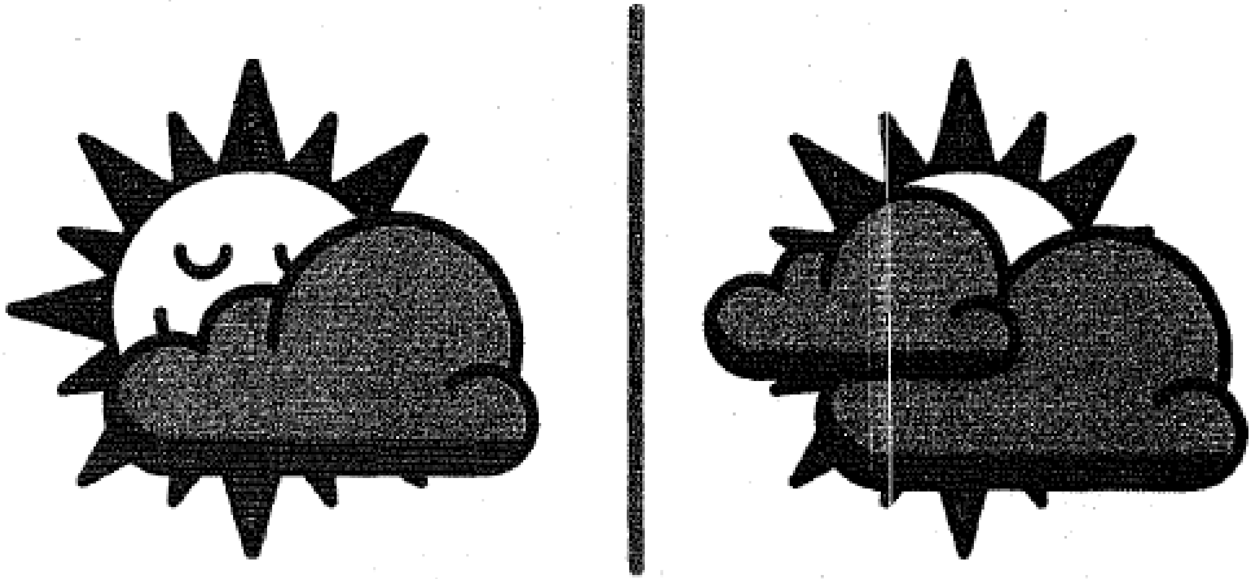


How to Make Your M&A Fees Predictable

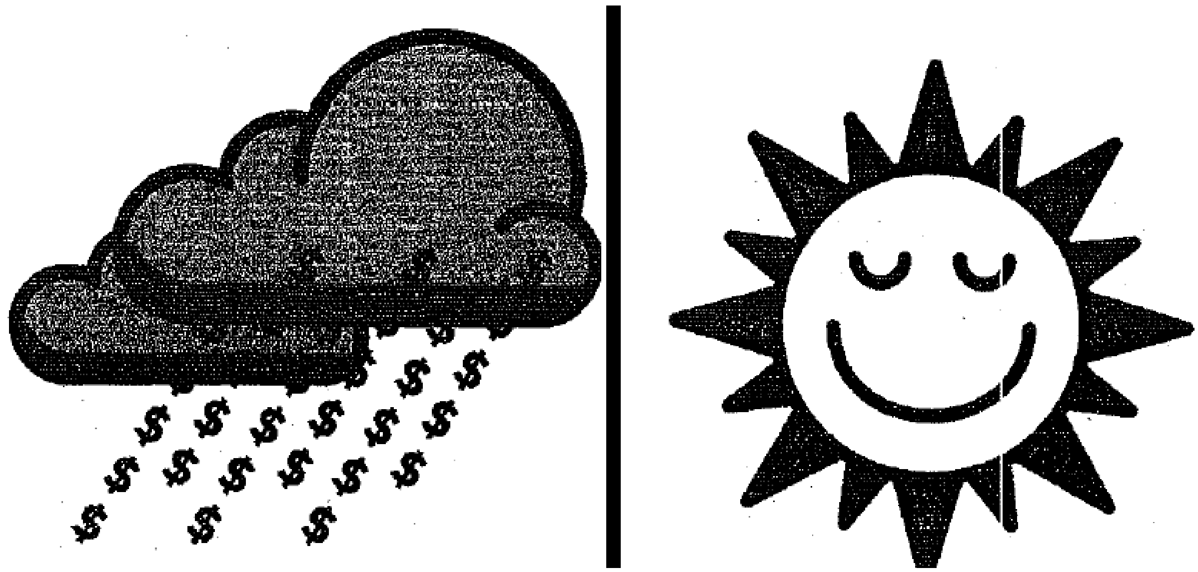
Any Surprise Is An Unpleasant One

By Rudolph S. Houck

Merger and acquisition lawyers are often asked to estimate or cap their legal fees. The client often assumes that a standard percentage formula will produce a reliable estimate or a fair fee. Unfortunately, the size of the purchase price has little to do with the amount of legal work involved. All parties, including attorneys, may assume that a bigger purchase price will support greater attention to detail and higher fees or that, similarly, a lower purchase price will pressure attorneys to keep costs down. But the same attention to detail may be needed in such low-purchase price situations to avoid liabilities that could far exceed the purchase price. Therefore, a correlation between price and fee is not direct, or even logical.

In fact, the biggest factor in generating legal fees is not the size of the purchase price but rather the risks and complexity of the transaction, and the attitude and sophistication of the client and the other side.

This article breaks down the legal costs of an M&A



transaction by subject matter, and by the stage of the transaction at which it occurs. Accurate cost estimates are based on close analysis of these factors.

SUBJECT MATTER

The subject matter of an M&A transaction can generally be divided into (a) contract and commercial work, (b) tax analysis and planning, (c) environmental analysis and compliance and (d) employee benefits and transition. Each of these four components is roughly equal in cost, complexity and risk, but specific complicating factors may increase legal costs. For example, a target may have substantial litigation to be analyzed and valued. Some targets have complicated real estate assets. Patents may require special review. Government licenses may be important to the target. And bankruptcy or antitrust exposure may warrant special attention.

On the cost-reducing side of the legal-fee balance sheet, a company without production facilities probably has few environmental risks, so the costs of environmental review may be quite small. If the seller depends on its accountants for tax strategy and deal structuring, those legal fees become accounting fees (although the tax lawyers must understand the structure to be able to advise the corporate attorneys as to certain risks and contract provisions). If the target has only rudimentary benefits plans, the benefits piece of the transaction may be minimal.

An attorney must estimate the extent and complexity of documentation to be reviewed in each of the subject matter areas. Hundreds of simple contracts, or complicated ones that are all the same, are easier to review than a few unique and complicated ones. The better drafted they are, the easier they are to evaluate. A stack of contracts two feet tall may be easy to review if most of the stack is made up of technical specifications and exhibits, but a two-inch stack may contain documents that are difficult to interpret. So the sheer volume of documentation is only a very rough indication of legal costs involved. Still a room full of documents will normally take much longer to review than a few ring binders, If the target has been represented by competent legal counsel in the past and due diligence documents are in good order, the process is simpler. If not, the documents may be scanty and reviewing attorneys may have to make their own, fully independent judgment as to the risks. Furthermore, important but badly documented third party relationships may have to be re-negotiated and new contracts entered into.

The preliminary phase of the transaction is usually relatively simple because the parties are motivated to make a deal. Therefore, the confidentiality agreement and letter of intent are usually non-controversial. Only if the letter of intent turns into a mini-acquisition agreement will the parties pay much attention to it. If it becomes the subject of intensive negotiation, this can mean that the hard part is over and the actual acquisition agreement has been hashed out.— or it can mean that the other side will want to negotiate every point.

Reviewing documents at a site other than counsel's office drives up the cost of due diligence. So does limited access to documents. If attorneys are unsure about a second look, they must assume that any contract provision could turn out to be important, and must be summarized. The more attorneys engaged in the review. (due to a shorter review window), the harder the job of integrating various reports and being certain that all members of the team know how they fit together, If the purchaser knows precisely what the due diligence team should look for, cost is reduced.

If the other side is a competitor, it may try to protect itself from a "purchaser" who really only wants a free look inside its competitor's organization.

If the acquisition target is only a line of products or list of equipment, the investigation can be simplified. If the target is the whole company, then the financial statements should give the buyer a fairly clear picture. If, however, the target is an insignificant piece of the seller's business, that piece may not be reflected in any detail on the seller's financial statements. The same is true about divisions whose financial statements partially reflect expense allocations by the parent. In either case the investigation has to be more diligent.

If the target is a publicly listed company, the SEC disclosure statements and public scrutiny give the buyer comfort.

Contract drafting costs are relatively easy to estimate. The more the transaction falls into a standard mold, the lower the drafting costs. Simplifying or customizing the contract adds to the cost. Turning a 70-page "standard" agreement into a 30-page simplified one drives the transaction costs up, not down. So do subordinate contracts such as employment agreements, technology licenses, transition services agreements and tolling agreements. If the transaction is an asset purchase, the costs of transferring certain assets like real estate and patents will be greater.

Separating two related businesses and selling them to two different buyers creates added complexities. Each buyer is faced with the question; what happens when the inter-company service contracts inevitably run out? The contracts must address these concerns.

NEGOTIATION COSTS HARD TO ESTIMATE

After the buyer's attorney has prepared the first drafts, the negotiation phase begins. The cost of this phase is the most difficult to estimate. In a simple transaction it can require one or two days of negotiations and a day of redrafting,- all carried on with only two attorneys in the room and occasional phone calls to the clients. More contentious negotiations can go on for weeks or longer, and engage whole reams of attorneys.

An unexpected risk or complication may cause the parties to completely restructure the transaction – for example, from a stock to an asset transaction. That transition is made even more complex if the parties agree that the transaction, now converted to an asset deal, will be tax-effected (and grossed up) as if it had remained a stock deal.

Signing the fully negotiated contracts should be relatively simple. Side letters may add a few hours. The greatest signing cost may be the creation and checking of contract disclosure schedules. The greater the load the client can bear in creating and reviewing these, the lower the legal costs. To do it properly the client employee tasked with the job must be fully familiar with the contract, and the interface between the contract provisions and what is being disclosed. Some lawyer review is essential; with the insertion of a few seemingly innocuous words on the schedule, such as "to Seller's knowledge," hours of hard-fought negotiations could be made worthless.

Fax machines and email make long-distance signings possible. If, however, close cooperation may be important between signing and closing, the added costs of a meeting and the personal commitment and good will generated may be money well spent.

CONTRACT TO CLOSING

Once the contract is signed, how many conditions to closing have to be fulfilled? Is a Hart-Scott-Rodino filing required? Will a divestiture be required to get approval? Are filings needed in other countries? Is a Phase II environmental investigation likely? Are third party consents required? Must key employees be courted and their employment agreements worked out? Must bank financing be obtained? All these steps add to the transaction cost. In addition to :egal work, lawyers invariably bill small amounts almost daily during this period, if only to monitor the process.

During this period the closing documents must be prepared. These are relatively simple. An important exception is the legal opinion. An opinion of seller's counsel as a condition to closing can add substantial cost if it bears on more than just the target's organization and the seller's authority to sell.

The closing itself can take from a morning to a day or two. As with the signing, simple transactions can be closed by fax or email. The side agreement is a grab bag of minor points and speeds up the closing. Occasionally really material contract points end up there and negotiating them can add hours to the closing process.

Finally, some costs accrue during the month or two after the closing. At minimum the lawyers prepare a closing book, but normally there are a few items that the parties have agreed to take care of post-closing. These can run up time disproportionate to their complexity. The parties frequently lose focus, and move on to other projects. The threat of holding up closing no longer motivates the parties. The lawyers face other deadlines. The parties often forget the derails of a complex transaction and the negotiations that may have led up to the side letter that allows the closing to occur.

CLIENT ATTITUDE IS KEY

As complicated as the factors already listed may be, the client's attitude and sophistication are equally important. On the most concrete level, is the client capable of organizing and running the transaction with relatively little help? Some clients do acquisitions many times a year and have smooth, well-versed teams. Others may be good business people, but not used to working together as a team, or to M&A practice. For example, some clients can carry out most of the due diligence, either as buyer or seller, thereby saving significant legal fees. But a badly done disclosure job adds to the costs throughout the transaction. A buyer may be more or less risk-averse or more or less familiar with the target and its business.

In particular, representing Europeans can mean explaining the U.S. legal system, M&A practice, and negotiating styles, all on the fly. A foreign client that brings its own, inflexible way of doing things will pay a price for having to educate and convince its own counsel, and then the other side. Satisfying the risk-averse client may require levels of research that drive the transaction costs up dramatically. Since the U.S. legal system seldom produces the same level of certainty as the continental systems, this is likely to be a frustrating process for both client and lawyer.

Note that having an investment banker on the buyer's side may raise or lower the lawyers' fees. If the banker carries some of the load otherwise handled by the lawyer, the lawyer's fees should go down. But the banker — whose fee depends in large part on closing the deal — may focus on strategizing and want the lawyer's input before making decisions. The banker's fee is generally not dependent on keeping legal fees down. While the teamwork and outcome may be superior, the transaction cost goes up too.

Of course the great unknown is often the attitude and competence of the other side. This is a factor that can be readily imagined. Is the other side focused and motivated to do the transaction? Is there basic trust and compatibility? Is opposing counsel competent or out of his or her depth? No matter how much the other side adds to the cost of the transaction, it will almost never agree to reimburse any of the extra costs it creates.

If the other side is a competitor, it may try to protect itself from a "purchaser" who really only wants a free look inside its competitor's organization. While the purchaser may be readily able to analyze information disclosed, the target may make those disclosures only in stages, thereby increasing the costs of the process. If the other side fears public disclosure that it is for sale, on-site investigations may have to be done on weekends, and access to key employees, customers and suppliers may be delayed.

Given all these factors, arriving at a reliable estimate of costs is quite difficult. How can the risk to the client of runaway fees be reduced?

Some Factors that Drive M&A Legal Costs Up or Down

- How old is the company? Does it have a long history to review?

- How complicated is the ownership and capitalization structure? Are there minority shareholders who may not cooperate?

- How many valuable employees does the company have? What measures have to be taken to hold on to these assets? Is it part of a mu ti-employer pension plan?

- How many important sites does it have? How many different jurisdictions are involved?

- Does the company ope-ate in a highly regulated or litigious subject area?

- Has the company been adequately insured by the same carrier for many years?

If the company has operations in multiple countries the legal costs may be substantially higher, and making a reasonable fee estimate becomes, more difficult, For example, even modest sales into 13razil may generate substantial antitrust legal and administrative fees. If the sales are low in Europe, antitrust compliance may be on a nation-bynation level, and not throigh the Ell Instead of one filing in Brussels, separate filings may be required in London, Paris and Berlin. Therefore, smaller sales result in higher legal costs.

Some buyers think they can control the costs by bringing the deal to their attorneys only at the last minute. But a client will be surprised at how many lawyers can work on a project in a week or 10 days. The hoped for cost savings can be more than outweighed by the inefficiencies of using many lawyers when only a few would have sufficed had there been more time. A short time line often leads to lawyers who are less than expert being dragooned into working on the project. Time for reflection and coordination are inadequate.

At the other extreme, allowing the project to drag on can result in every lawyer billing a few tenths of an hour every day with little to show for it. If the deal goes too slowly, key players may be pulled onto other deals. Finding the right rhythm is critical and comes with experience. A good investment banker can earn part of his or her fee by moving the deal along at a reasonable pace.

With the insertion of a few seemingly innocuous words, such as "to Seller's knowledge," hours of hard-fought negotiations could be made worthless.

PRODUCTIVE WAYS TO REDUCE FEES

If time and the transaction permit, try to do the due diligence in two or three stages. Overall the cost may be a bit greater, but if the business people decide not to do the transaction, they will not have paid for a thorough due diligence report of a company they will not buy. An auction proceeding may not permit this solution. There, the bidder who has been most aggressive in due diligence may have an insurmountable time advantage.

The more work the client can competently perform, the lower the law firm fees should be. This may apply to matters such as organizing or reviewing the data room, focusing on key deal points, structuring the transaction and negotiating employment agreements.

The client may also determine which law firms will handle which portions of the transaction. This technique can bring its own tensions and inefficiencies. Certainly local real estate transactions are often carved out and given to local counsel. The same is true of state environmental laws. Much beyond this, rivalries among the law firms may arise and make coordination a bigger issue. There gets to be, for example, a greater tendency to document any disagreement between the firms, so that *if* a problem arises one can prove that its advice was rejected by the other. This same problem can arise in a single law firm that is not fully integrated.

Art important benefit a lawyer brings to the client is independence. Setting up a contingent fee situation, where the attorney is paid only if the deal goes through, reduces that independence. However, a small discount of perhaps 20 percent if the deal does not go through should not significantly affect judgment. On the other hand, the lawyer who takes this risk generally wants a sweetener if the deal succeeds. The swing of 40 percent (-20 percent vs +20 percent) may be enough to affect judgment adversely.

The discount may apply once the estimated fee for the transaction has been reached. Even here, the discount should not be so great as to incentivize the attorneys to close the deal regardless of their misgivings.

A client who shops around for law firms may obtain some concession by promising the firm other deals. If the client is very active in M&A transactions, this may be a real incentive. Note, however, if the entity promising the string of transactions is the investment bank, then the client has lost its lawyers' independence by being less likely to disagree with its meal ticket.

A law firm may be willing to adjust the timing of payment of it: fees over time, or to defer some of such fee:; to a time when the client is better able to pay.

If an M&A buyer wages a beauty contest to select its counsel, it should be prepared to talk knowledgeably about legal fees. The basic building blocks of the fee are the hourly rates of the attorneys, but other factors are more important. How much experience do the attorneys have? Will the firm commit to making the attorneys who make the presentation available for the transaction? Who will the contact partner be? What has been the range of fees billed by the firm for similar transactions? Does the firm normally work with clients who pay the fees themselves, or do they deal in other peoples' money?

In judging "blended rates," bear in mind that the more young attorneys are involved, the lower the blended rate. Thus, if there are a great many legal issues to be researched or rooms full of disclosure materials, the overall fee may be higher, but the blended rate lower. If complex drafting or intense negotiations are called for, the work is more partner-intensive, and the blended rate higher.

Although expenses are of secondary importance, the firm's attitude about them can be telling. Is its phone and copy system a profit center? Does it always do bulk copying inhouse, or does it send it out? What are its travel policies? Do lawyers fly business or coach? Do they charge for travel time? When do secretaries bill for their overtime? If the firm is really good the client may simply have to accept these charges, but it should know about them.

TYPICAL FEE RANGES FOR A STOCK OR ASSET ACQUISITION

	Pre Due Diligence	Due Diligence	Contract Drafting	Negotiating	Signing Closing	Closing,	Post Closing / Total
Corp.	5-10,000	10-25,000	10-15,000	10-50,000	5-10,000	5-15,000	5-10,000 / 50-125,000
Tax	5-25,000	5-15,000	5-10,000	5-10,000	0-5,000	0-5,000	5-10,000 / 20-80,000
Env.	0-5,000	10-50,000	5-10,000	5-10,000	0-10,000	0-5,000	0-5,000 / 20- 90,000
Empl.	0-5,000	10-30,000	5-10,000	5-10,000	0-20,000	0-10,000	0-40,00 / 20-125,000
Total	10-45,000	35-120,000	25-45,000	25-80,000	5-45,000	5-35,000	10-65,000 / 115-435,000

Billing practices can be crucial. What information do the firm's bills contain? How much detail is provided? How quickly are invoices rendered (so the client can keep close watch on the costs as they mount)?

One common client complaint is that attorneys charge for internal discussions. The U.S. legal system is too complex to produce individual lawyers who can execute such transactions without consulting others. It is probably most efficient not to try to eliminate these discussions, but to have the firm conduct them in an organized way, by group entails or periodic roundtable discussions. The client may want to task its principle lawyer contact with being a gatekeeper: No attorney on the team may engage another attorney in the firm without the gatekeeper's consent.

What can be done to protect against low-balling or underestimating the cost of the transaction to get the client committed to the firm? It is difficult to switch law firms mid-deal. The client should understand that some lawyers low-ball knowingly, while others are simply optimistic or bad estimators. The best indication of good lawyers at a reasonable price is a stable of satisfied clients. Here a potential client should not be impressed by high profile clients on the list unless the potential client is a similar company with similar problems.

Another method – largely psychological – of keeping fees in check is having the law firm submit its estimates in writing. Any time the charges exceed those originally estimated – and that almost inevitably happens – the lead attorney should be obligated to give an explanation. This technique puts pressure through the system to pay attention to the budget. The problem is that the client maybe the cause of the higher fees.

All of these methods presume that attorney time is being kept accurately. With computerized time keeping, a law firm can provide detailed billing information in a matter of hours. But the longer an attorney waits to enter time, the less reliable it becomes. The client may reasonably tell the relationship-attorney that accurate calculations of legal fees may be requested at any time during the project, not lust during the normal monthly billing cycle. This warning should increase the time-keeping discipline of the lawyers. Asking for the information as each phase of the project ends permits the client to compare results to estimates before too much damage is done.

Finally, the client can reasonably ask what non-standard billing arrangements the law firm offers in this type of transaction.

Having set forth in detail why estimating fees is no easy task, we illustrate with the above chart, which shows typical ranges for a stock or asset acquisition transaction of average complexity.

Yes, at the outset of the transaction the maximum can be two to three time the minimum. The high end of the estimate presumes that substantial complications arise in all aspects of the transaction, due to some or all of the many variables described above. The point of the chart is not to set a reasonable rate, but to show the detail a client could reasonably expect in a preliminary discussion of fees.

Estimating the legal costs of doing an acquisition is tricky business. Besides the normal difficulties of predicting the unknown, the lawyer making the estimate wants to set it low enough to get the project, but not so low that it creates an unhappy client if the final fee substantially exceeds the estimate. Few clients praise their attorneys for coming in below estimate but many complain if the fees balloon, regardless of the cause. No simple solution exists, but a thorough breakdown of the cost factors and frequent, open discussions with the client during the various stages of the transaction will reduce the likelihood of unpleasant surprises.

Rudolph (Rob) Houck is a partner at the New York office of Alston & Bird and chairman of the firm's cross-border corporate and *transactions group. He specializes in representing businesses* from *German-speaking countries. Now at Eaton & Van Winkle LLP.* www.evw.com