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C-LEVEL INSIGHTS FOR BUSINESS LEADERS

Finder's Fee Litigation Common In Mergers and Acquisitions

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Litigation by those seeking a finder's fee for their role in bringing parties to the table in a transaction is ubiquitous. Thus it makes sense for prudent business people to understand the rules, lest they meet a process server, armed with a finder's summons and complaint, at an unplanned get-together.

A finder is a party who brings potential actors together for the purpose of completing a transaction, without participating in the negotiations that follow. Just about anybody – customers, supplier employees, lawyers, accountants, business broker or investment bankers – may claim a finder's fee.

Brokers (who may also be finders) assist the parties to negotiate the terms and conditions of the deal. Unsurprisingly, finders are typically paid less than brokers, as their time and effort in bringing the deal forward are usually more limited than those of brokers. Moreover, brokers are by convention the agents of those on one side or the other, with responsibilities governed by the law of agency. Although finders may look to one side or the other for compensation, they are not, strictly speaking, the agents of either.

While there is no limit to the kinds of transactions that may give rise to a finders-fee claim, the most common are mergers and acquisitions, private placements, public offerings, and joint ventures and deals involving the transfer or use of intellectual property such as licensing agreements.

LIABILITY ISSUES

The outcome of finder's fee litigation is governed principally by state case and statutory law. Outcomes will vary based on judicial interpretations or common law principles, such as whether plaintiff was the "procuring cause" of, for example, a real estate deal, and statutory interpretations (i.e. whether a state's "statute of frauds" that bars brokerage fees claims not reduced to writing is operative). Such defenses can stop the would-be finder's lawsuit early on.

Finder's fee lawsuits typically assert a variety of causes of action, such as breach of contract, defendant's unjust enrichment at plaintiff's expense, or defendant's assumption of an implied obligation to pay plaintiff. In rare circumstances, plaintiff may assert a fraud claim based on RICO. Defenses include the absence of a proper real estate or securities broker's license, statute of frauds defenses and, inevitably, that plaintiff did not serve as the catalyst for the deal in question or was simply volunteering its services.

Thus, the outcome of finder's fee lawsuits is significantly fact-driven. Critical questions are:

- Whether plaintiff initiated the idea for the transaction or the idea was already known to the parties or had been brought to their attention by third parties.

- Whether plaintiff obtained a written agreement from the party from whom payment is sought, tried to obtain one, or whether evidence can establish that defendant orally agreed to pay a fee. If so, was the fee amount quantified or determinable by formula – for example, a percent of transaction value?

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- The steps taken by the plaintiff to advance the transaction. Did plaintiff arrange for an initial meeting between the parties at a designated time and place, and if so was plaintiff in attendance?

- Whether other services were performed, such as passing along a term sheet or letter of intent.

- The steps plaintiff did or did not take to assert its claim after initial rebuff by defendant.

DETERMINING DAMAGES

Absent a written agreement between the parties, damages in finder's fee cases are proved or disproved by determining the transaction value of the deal plaintiff alleges it engineered, and assigning a certain percentage of that value as a finder's fee.

Damages are determined partly by empirical research, partly by the nature and extent of plaintiff's work in the transaction, and partly through the exercise of informed judgment. Many of the same elements used to determine liability impact damages as well. In proving transaction value in the case of a merger or acquisition, private placement or IPO, such value is usually determinable without the need for independent analysis. Thus, in the case of a publicly announced M&A deal, transaction value is in the public domain and readily determinable. Even in the case of a non-publicly disclosed merger or a private placement, a review of the relevant deal documents produced during discovery will typically be dispositive.

Finder's fee claims arising out of joint ventures or intellectual property transfers represent a trickier area of inquiry. Value will be realized down the road, by the cash flows they generate. Determining transaction value in such instances requires application of the conventional going-concern valuation approaches – cost, income and market.

The cost approach is most typically demonstrated by marking up or down a concern's recent balance sheet from cost to market, usually by appraisal, to result in a kind of replacement cost outcome.

The income approach most commonly applies discounted cash flow analysis to the cash flows in question. Here, future cash flows are discounted over a designated time period at an appropriate cost of capital. However, to apply this methodology to a joint venture or strategic alliance is anything but conventional. Assuming a valuation date in the middle of joint venture, historical and projected cash flows are compounded and discounted, respectively, to their present value, in order to yield transaction value. If defendant's joint venture interest ends on a date certain, there will be no terminal value calculation beyond that date.

The market approach employs comparative or guideline companies whose businesses are useful for comparative purposes to that of the company to be valued. In M&A situations, comparative transaction analysis involving sales of control is employed in a similar fashion.

Assume the following hypothetical: Plaintiff claims a finder's fee from the sale, for $500 million on May 15, 2005, of a closely held ball bearing manufacturer to a larger competitor. Plaintiff asserts that the deal took place as a result of plaintiff's introduction of the parties. In this instance, transaction value can be determined by examining the Agreement and Plan of Merger to identify the cash consideration in the transaction. If

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some or all of the price was payable in the shares of a publicly held buyer, transaction value can easily be calculated as well.

We know of no databases that track finder's fees, but a database for publicly disclosed M&A transactions called "Thompson ONE Banker" may be used as a first step in the process of determining a reasonable fee. The Thompson database can be accessed by transaction date, transaction size and by specific industry to fit the facts of a particular transaction. In the case of our ball bearing hypothetical, one would attempt to develop a universe of transactions involving ball bearing producers – or absent such a universe, in fabricated metal parts – over a multi-year period and within a size range that brackets the $500 million transaction value.

Finder's fee litigation is an unwanted consequence for the unwary. My final words are contained in a piece of doggerel written years ago by the vice president, corporate development of a Fortune 500 Company, who for obvious reasons prefers to remain anonymous.

My advice when it comes to a merger
is beware of the work of a scourger.
Keep your eye on the deal
if you're starting to feel
that the scourge of the merge is the urger.

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