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Damage Computations in Finder's Fee Litigation—Issues for the Expert

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Litigation by those seeking to obtain a finder's fee for their role in bringing parties to the table in a transaction is ubiquitous. A *finder* is a party who brings potential transactors together to complete a transaction without participating in the negotiations that follow.[1] Just about anybody—customers, suppliers, employees, lawyers, accountants, business brokers or investment bankers—may claim to be finders.[2] Although finders may look to one side or the other (or both) for their compensation, they are not, strictly speaking, agents of any one side. Often there is no written agreement among the parties that spells out the terms of their relationship and any finder's fee for a particular transaction—hence the numerous lawsuits that arise when the deal closes and the "finder" demands a certain percentage of the transaction value.

While there is no limit to the transactions that may give rise to these claims, the most common are mergers and acquisitions, private placements, public offerings, joint ventures and deals involving the transfer or use of intellectual property such as licensing agreements. Expert testimony in finder's fee litigation may best be served by experienced business appraisers and M&A advisers, capable of informing the trier-of-fact on valuation matters or common compensation practices for M&A intermediaries.

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In a nutshell, absent a written agreement between the parties, damages in finder's fee cases are determined by a two-step process: 1) calculating the transaction value of the deal; and 2) assigning a certain percentage of that value as a finder's fee.

When transaction value is not self-evident

In many mergers, acquisitions, or private placements, transaction value is usually clear or determinable without the need of significant independent analysis, because—as in the case of a publicly announced M&A deal—transaction value is in the public domain. Even in non-publicly disclosed mergers or private placements, a review of the relevant deal documents will typically be dispositive of transaction value.

What of finder's fee claims relating to deals in which transaction value is less easily determinable, such as strategic alliances, joint ventures and many intellectual property transfers? This inquiry is trickier, particularly when the finder seeks remuneration from only one party without an equal sharing of risks and benefits. Public disclosures for these deals, even when available, may be insufficient to determine transaction value without independent analysis.[3] Determining transaction value in these cases requires applying the three conventional going-concern valuation approaches: cost, income and market.

Consider the following hypothetical: Plaintiff claims a finder's fee from the introduction of two parties, Partner A, a manufacturer of mobile phones, and Partner B, the owner of certain entertainment-related technologies. The partners have recently agreed to a joint venture to manufacture, market, and distribute a line of mobile entertainment devices. Plaintiff asserts that the partnership came about through its introduction of the two parties, but claims remunera-

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tion from only one (Partner B), who allegedly agreed to compensate Plaintiff as finder. Partner B claims never having made an agreement with Plaintiff and that Plaintiff acted as a mere volunteer.

Partners A and B have already entered into a five-year operating agreement outlining the joint venture. Partner A has agreed to manufacture and deliver the mobile devices at specific price per unit, in exchange for a 50% equity share in the venture. Partner B will provide rights to the requisite technology and marketing services for an agreed upon management fee and a 50% equity share. Both partners will provide minimal seed capital to launch the new company. After the five-year term expires, all technology rights will revert to Partner B and the partnership will be dissolved.

Joint ventures such as this one can pose a unique challenge to appraisers. Setting aside the difficulties in estimating the value of an early-stage company with unproven revenues and expenses, there is the additional complication of attempting to estimate the value that may accrue to each of the joint venture's partners. Joint ventures are often complex arrangements, structured to anticipate and mitigate myriad contingencies and potential conflicts between the partners. In valuing a joint venture to one of its partners, it is critical to understand its structure, each partner's responsibilities and options, and reasonable expectations regarding the joint venture's contemplated life.

Consider, for example, the relatively short life span of most joint ventures.[4] In anticipation of the venture's termination, many agreements provide partners with exit strategies, which may come in the form of put or call options on the enterprise. Indeed, authorities have suggested that option theory may be used to value the joint venture.[5] Such call and put options add value and should be considered when estimating the value of a partner's interest in a joint venture.

Returning to our hypothetical, we can estimate the fair market value of Partner B's interests in the joint venture through the classic going-concern valuation methods. A full treatment of the issues an appraiser may face in this and similar situations is beyond the scope of this article, but the hypothetical highlights factors that may require particular attention. Note the Partners' equal equity interests should not lead to the conclusion that they expect equivalent income streams over the life of the venture; or, assuming perpetual life, in perpetuity. A DCF analysis might include a terminal value for Partner B but not for Partner A, whose equity interests expire at the end of the joint venture's five-year term.

It is also not unusual for a joint venture to transact with one or more of the constituent companies, to the latter's benefit. The extent to which a joint venture

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agreement increases a partner's pro rata portion of transaction value depends on the nature of the partner's role.[6] For example, in addition to holding equal equity stakes in the venture, the partners in the hypothetical will each contribute goods or services; the appraiser should consider such income streams if they inure to the value of the partner's equity account.

Formulas for the finder's fee

After determining the value of the transaction that a finder claims to have engineered, a certain percentage of that value must be apportioned as a finder's fee. There is no standard finder's fee formula.[7] Finder's fees (typically measured in basis points in larger deals) will vary depending on the finder's involvement in the transaction and the transaction size, with a higher percentage payable in smaller deals and a lower percentage in larger deals.[8]

Some have used variations of the "Lehman Formula"—such as the "Double Lehman," the "Stuttering Lehman," the "Gap Lehman," or the "New Lehman"—to determine fees payable to finders.[9] The original Lehman Formula calls for a fee equivalent to 5% of the first million of transaction value, 4% of the second million, 3% of the third million, 2% of the fourth million, and 1% of the remaining value over four million.[10]

The simplicity of the Lehman Formula may explain its appeal to those attempting *ex post* estimates of finders' fees. But blindly applying any of the Lehman variants is inadvisable. The Lehman Formula has been used to compensate finders in certain situations (typically small mergers or acquisitions), but it was originally devised as a means by which to calculate fees due investment banks that brokered mergers and acquisitions.[11] Even in its original context, the Lehman Formula has generally not been used to estimate brokers' fees in large transactions, and indiscriminately applying the formula may result in counterintuitive results.[12]

For example, consider the sale of a company with a capitalization of $800 million. The various Lehman Formulas would call for finder's fee payments of at least $8 million, which would almost surely dwarf the fees paid to the deal's investment banks, which expended greater time and effort on the transaction. Further, in litigation, a court may be unpersuaded by an expert who, with empirical data available, derives conclusions unsupported by such data.[13]

How, then, might one estimate an appropriate finder's fee? We know of no database that tracks finders' fees. But a reasonable first step would be to determine a normal and customary fee due to brokers involved in similar transactions. Brokers (who may also be finders) assist the parties in negotiating the terms and conditions of the deal. Not surprisingly, as they have a smaller role in bringing the deal forward, finders are typically paid less than brokers.[14]

How much less? The beginning of an answer may result from a search of publicly available databases for actual fees paid to intermediaries in transactions similar to those for which the finder seeks compensation. Databases such as Thomson ONE Banker (http://banker.thomsonib.com) include the fees paid to brokers in a variety of transactions, which can be sorted by industry, date, transaction size, and services rendered. The database also differentiates fees for fairness opinions and other broker services that are unrelated to finders' work, which should be excluded. The resulting empirically determined broker's fee (say, 50 basis points where transaction values in a given industry at times close to the valuation date are between $500 million and $1 billion) provides a number from which a full broker's fee can be computed.

Estimating exactly how much less than a broker a finder should be paid is a "facts and circumstances" matter, related to how much or how little the finder in a particular case did to move the deal forward—and on this score, there will be many variables to consider.[15] Because the ultimate amount will hinge on the parties' conflicting narratives, the expert analyst may not have a sufficient set of undisputed facts from which to provide a point estimate of damages with a reasonable degree of certainty. Keep in mind that many of the disputed issues affecting liability will also impact damages. It will be the attorneys' responsibility to establish or disprove liability and the amount, if any, of damages. Simply accepting either side's narrative may adversely affect damage computations, as the trier-of-fact may ultimately determine that a party has

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established all, some, or none of its narrative. One solution is to provide a range of damage calculations that might, for example, fall on a continuum from zero for a mere volunteer to a full-sized fee for a true broker.[16]

Final words

1. Be aware of the distinctions between liability and damage issues. Unless specifically requested to respond to whether the finder's work was typical for a person so engaged, avoid expressing a conclusion that would affect liability.
2. Ground any analysis and calculations of damages in the facts of the case.
3. Document all analysis by reference to classic, accepted valuation methods. Where one methodology may not be applicable, demonstrate to the trier-of-fact why the rejection of that approach is warranted.
4. Since it is impossible to determine *ex ante* how much of either party's narrative will be accepted by the trier-of-fact, provide a range of values that incorporates assumptions at both ends of the spectrum.

1 Arthur H. Rosenbloom, "'Finders Fees', Who Pays What to Whom?" *D&B Reports* (Dec 1981).

2 BenDaniel, David, Rosenbloom, Arthur, and Hanks, James, *International M&A, Joint Ventures & Beyond* (2nd Ed., Aug. 2002), John Wiley & Sons Inc., p.444.

3 Databases such as Thomson SDC Platinum™ are sources of publicly disclosed joint venture data, and include estimated annual revenue, net assets, and capitalization. But unlike M&A databases, which set forth transaction values and broker fees, the joint venture databases seldom include intermediary fees.

4 Yan, Aiman and Luo, Yadong, *International Joint Ventures: Theory and Practice*, M.E. Sharpe, Inc. (2001), p.280.

5 Ulrich Pape and Stephan Schmidt-Tank, "Valuing Joint Ventures Using Real Options," ESCP-EAP Working Paper, Nr. 7 (Sep 2004), *working paper*, Social Science Research Network (SSRN); www.ssrn.com.

6 Consider a Berle and Means type analysis: If a joint venture participant earns fees from tasks that a third party could have been performed, such as acting as the general contractor in a real estate joint venture, the efforts are related to labor and not ownership, and should not be counted in determining transaction value, which relates solely to ownership. *See*, Berle, Adolph and Means, Gardner, *The Modern Corporation and Private Property*, Macmillan (1932).

7 Wendy Fried, "The Secret World of Finders," *Inc.com* (March 2005). "In the words of Hugh H. Makens, the former chief securities regulator for Michigan who probably has delved deeper into this world than anyone else, the work of finders constitutes 'a vast gray market.' There is no standard fee."

8 Silberstein, Elfenbein and Ahern, "When You Are Not the First Call," *Finding The Right Finder*, Debevoise & Plimpton, Private Equity Report, Vol. 6 No. 3, p.15. (Spring 2006). "In fact, brokers or finders are still very active in the sale of mid-sized family businesses and small transactions." *See also* Reed, Stanley Foster and Lajoux, Alexandra, *The Art of M&A: A Merger Acquisition Buyout Guide*, McGraw-Hill (3d. Ed. 1998) ("Reed and Lajoux"), p. 52.

The authors suggest that finders' fees are negotiated in transactions exceeding $100 million in value.

9 Bradford Malt, "Selected Materials on Acquisition Basics," ALI-ABA Course of Study, Corporate Mergers and Acquisitions (Sept. 2003).

10 Lehman Brothers developed the Lehman Formula in the 1970s to calculate the compensation a broker should receive from handling a large transaction for a client.

11 Reed and Lajoux, p. 52.

12 Rock, Milton H., Rock, Robert H., and Sikora, Martin, *The Mergers and Acquisitions Handbook*, McGraw Hill Professional (1994) ("Rock, Rock and Sikora") p.138. "[T]he Lehman fee would be excessive in the case of a finder that merely introduces the parties and does not perform many of the functions ordinarily performed by a broker."

13 Robert M. Lloyd, *Proving Lost Profits After Daubert: Five Questions Every Court Should Ask Before Admitting Expert Testimony*, 41 U. Rich. L. Rev. 379 (2007).

14 Hugh Makens, "Finders In No-Man's Land," *The Blue Sky Bugle*, ABA Committee on State Regulation of Securities, Vol 2002, No.1 (March 2002). "[T]he term (finder) is defined as 'a person, be it a company, service or individual, who brings together buyers and sellers for a fee, but who has no active role in negotiations and may not bind either party to the transaction."

15 "An intermediary's compensation should depend not only on the size of the deal but also on the nature and extent of the services rendered." Rock, Rock and Sikora, p.138. *See also* Reed and Lajoux, p.55, which states that when investment banks receive a lead for a deal that eventually closes, they typically pay approximately 10% of their fees to the finder.

16 Reed and Lajoux, p.57.