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Finder's Fee Agreements: Pitfalls and Considerations

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Body

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In today's frenzied dot.com environment, the rush towards capital formation and strategic alliances often leads companies to engage the services of a finder to assist them in locating investors and raising capital.

However, unsuspecting finders may become unnecessarily subject to regulation under the federal securities laws. This article examines how finder's fee agreements are treated under New York law generally and what potential pitfalls the drafter of finder's fee agreements should avoid.

New York law recognizes a finder as someone who finds, interests, introduces and brings parties together for a business transaction that the parties themselves negotiate and consummate.[1] Unlike a broker, a finder has no duty to bring the parties to an agreement, but instead acts as an intermediary or middleman.(iMoore , **1998 WL 67664, *4.)**

As one court has explained, [f]inders find potential buyers or sellers, stimulate interest and bring parties together. Brokers bring the parties to an agreement on particular terms.[2] In the corporate financing context, a finder's compensation is generally based on a percentage of the amount invested by one party or, in circumstances involving mergers and acquisitions, a percentage of the transaction value.

Causation Requirement

For a finder to recover under the typical finder's agreement, there must be a causal relation between the introduction of the parties and the ultimate conclusion of the transaction.[3]

Moreover, courts have consistently required that the finder show more than that his role was a necessary but-for condition. (See **Moore**, and **Karelitz v. Damson Oil Corp**., 820 F2d at 531.) Rather, the finder must show that the final deal flowed directly from the introduction. Accordingly, the finder typically must establish a continuing connection between the finder's service and the ultimate transaction.

One commentator has observed that this continuing connection is not dependent upon the finder's participation in negotiations, and a finder's fee may be payable even though a third person brings the party to agreement. Thus, if a finder introduces a prospective investor who enters into negotiations that are abandoned and later resumed, the causation requirement is probably satisfied if the renewed negotiations stem from the original introduction. (See B. Fox & E. Fox, **Corporate Acquisitions and Mergers**, at 30.04(3)(1986)).

For example, in **Simon v. Electrospace Corp.**, 32 A.D.2d 62 (1971), a finder introduced the defendant Electrospace Corp. to Louis Taxin for the purpose of arranging a merger with one of Mr. Taxin's companies. The finder had entered into an agreement providing that in the event you can effect the sale of the stock of this corporation ... by introduction to a party or parties with whom a transaction will be thereafter consummated, then 5 percent of the gross value of the transaction will be paid as a commission to you at the time of closing.

Although nothing came of the initial meetings, Electrospace and Mr. Taxin resumed their negotiations eighteen months later. The Court of Appeals, in affirming the Appellate Court's decision that the finder was entitled to a finder's fee, held that the evidence was sufficient to establish a continuing connection between the finder's initial efforts and the merger that came about. (See **Simon v. Electrospace Corp**., 28 N.Y.2d 136, 142 (1971)).

Chain of Introductions

Some courts have directed the payment of a finder's fee even in situations where the consummation of the transaction at issue culminated not directly from the finder's initial introduction but indirectly from a chain of introductions initiated by the finder's introduction. For example, **Defren v. Russell,** 71 A.D.2d 416, 422 (1st Dept. 1979), involved a finder's fee dispute in connection with a series of introductions that allegedly culminated in the acquisition of Bio-Dynamics, Inc. by IMS International Inc. The plaintiff and Thomas Russell, Bio-Dynamic's president, had entered into a finder's agreement that stated that plaintiff would receive $75,000 for the consummation of the acquisition of all of the stock of Bio-Dynamics with or through Loeb, Rhoades & Co. and/or one of its affiliates. After execution of the finders agreement, plaintiff introduced Russell to Peter Dixon, a representative of Loeb, Rhoades who, along with plaintiff, was going to assist Mr. Russell in his efforts to sell the Bio-Dynamics stock. However, approximately 10 months later, Mr. Russell told plaintiff that he was going to sell the Bio-Dynamics stock on his own. In fact, unknown to plaintiff, Mr. Russell continued to work closely with Mr. Dixon for the next two years in an attempt to sell the Bio-Dynamics stock. After plaintiff made the initial introduction of Mr. Russell to Mr. Dixon, there was a long series of introductions, which eventually culminated in the acquisition of Bio-Dynamics by IMS. Id.

In addressing whether plaintiff was entitled to a finder's fee pursuant to the finder's agreement, the court recognized that the more narrow question presented was whether plaintiff was entitled to recover on the basis of Loeb, Rhoades' efforts on Russell's behalf. Preliminarily, the court noted that the finder's agreement provided that the consummation of the acquisition with or through Loeb, Rhoades would fulfill the terms of the agreement with respect to the plaintiff's performance thereunder. The court then recognized that there was not the slightest indication that Mr. Russell would have become even aware of the existence of IMS except through the diligent services performed by Mr. Dixon. Thus, the court held that in view of the fact that the Bio-Dynamics stock was sold to IMS through the efforts of Loeb, Rhoades, the plaintiff was entitled to recover a finder's fee of $75,000. Id.

Similarly, in **Seckendorff v. Halsey, Stuart & Co.**, 234 A.D. 61 (1931), a plaintiff approached the investment banking firm of Rogers Caldwell & Co. to determine if it was interested in arranging bond financing for certain properties located in Washington, D.C. After the plaintiff described the properties, Rogers Caldwell entered into an agreement which provided that the plaintiff would receive a 1 percent commission on the par value of any securities distributed to the public and 2 percent of any securities that Rogers Caldwell may receive as a bonus for handling the transaction.

After signing the agreement, Rogers Caldwell approached the investment firm of Halsey, Stuart & Co. to inquire whether Halsey would be interested in heading the bond syndicate. At this time, the plaintiff's agreement was brought to the attention of Halsey. However, Halsey indicated that it was not interested in participating in the bond financing. Nevertheless, one year later, Halsey and Rogers Caldwell developed a different deal structure and ultimately financed the Washington D.C. properties without the plaintiff's knowledge.

In holding that the plaintiff was entitled to his commission under the agreement, the court recognized that Rogers Caldwell and Halsey were in reality, partners or, at least, joint adventurers, and that Rogers Caldwell could legally bind its associates Halsey.... Furthermore, the court found that without the plaintiff's introduction, there never would have been any bond issue because plaintiff himself was alone responsible for finding this business and bringing it to the defendants' attention. Accordingly, the court held that the one-year lapse in negotiations and different deal structure did not preclude the jury's finding that the transaction flowed directly from the plaintiff's original introduction.

Both the **Defren** and **Seckendorff** cases illustrate that drafters of finder's fee agreements should be cognizant of the chain of introductions concept. Accordingly, when drafting finder's fee agreements, the drafter may wish to include a provision entitling the finder to a fee if a transaction is ultimately consummated with any party that resulted from the finder's original introduction. Such a provision may, at the very least, clarify the scope of the finder's relationship and may avoid protracted litigation should a transaction be ultimately consummated with a third-party that was not directly introduced by the finder himself.

Federal Securities Laws

The federal securities laws generally govern whether a finder must register as a broker-dealer, or conduct its activities through a registered broker-dealer. Section 3(a)(4) of the Securities Exchange Act of 1934 defines broker as any person engaged in the business of effecting transactions in securities for the account of others. Section 3(a)(5) of the Exchange Act defines dealer as any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.

Section 15(a)(1) of the act provides that it is unlawful for any broker or dealer to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security unless such broker or dealer is registered with the Securities and Exchange Commission.

As one commentator has noted, although a pure finder may induce the purchase or sale of a security within the meaning of Section 15(a)(1), he or she is not normally a broker because he or she effects no transactions. (See Louis Loss, **Securities Regulation**, Volume VI, page 3004, (1990)).

In addition, the staff of the Securities and Exchange Commission has issued certain no-action letters further interpreting these provisions. For example, in a no-action letter the staff explained:

[A]n intermediary who did nothing more than bring merger or acquisition-minded people or entities together and did not participate in negotiations or settlements between them probably would not be a broker in securities and not subject to the registration requirements of Section 15 of the Exchange Act; on the other hand, an intermediary who plays an integral role in negotiating and effecting mergers or acquisitions that involve transactions in securities generally would be deemed to be a broker and required to register with the Commission. (See **Henry C. Coppeltd/b/a/ May Pac Management Co.**, 1973-1974 Fed. Sec. L. Rep. (CCH), paragraph 79,814.)

In light of the SEC's no-action letter, potential finders should be wary of performing anything more than an intermediary role in bringing parties together for the purposes of consummating business transactions involving the purchase or sale of securities, otherwise they run the risk of being deemed unregistered brokers pursuant to the federal securities laws.

In particular, finders should avoid offering investment advice in connection with their services. Accordingly, finders, and drafters of finder's fee agreements, should preliminarily determine what the finder's role will be in connection with any potential finder's arrangement. Furthermore, finders and drafters of finder's fee agreements, should explore whether the finder's role will be restricted to merely bringing two parties together for a business transaction or whether the finder will assume a more active role in negotiating and structuring the ultimate financing arrangement. Only by examining the finder's duties can the practitioner determine whether the finder must register as a broker pursuant to the federal securities laws.

Conclusion

While the use of finder's fee agreements have become commonplace, finders and practitioners alike, must be wary of potential pitfalls that may arise from such agreements. Before drafting any finder's agreement, the practitioner should first determine the extent of the finder's role in consummating the transaction at issue. In addition, the practitioner should evaluate whether the finder may be subject to regulation under the federal securities law. Finally, after the practitioner has addressed these considerations, the practitioner may want to include a provision in the finder's fee agreement to ensure that the finder will be compensated from transactions that culminated from a chain of introductions initiated by the finder.

(1) **Moore v. Sutton Resources Ltd.**, 1998 WL 67664, *4 (S.D.N.Y. 1998) (citing **Northeast General Corporation v. Wellington Advertising Inc.**, 82 NY2d 158, 163, 604 NYS2d 1 (1993).

(2) **Train v. Ardshiel Assoc. Inc.**, 635 FSupp. 274, 279 (S.D.N.Y. 1986), aff'd without opinion, 805 F2d 391 (2d Cir. 1986).

(3) See **Moore**, *4; see also **Simon v. Electrospace Corp.**, 28 NY2d 136, 142 (1971); **Edward Gottlieb Inc. v. City & Commercial Communications PLC**, 200 AD2d 395, (1st Dept. 1994); **Karelitz v. Damson Oil Corp**., 820 F2d 529, 531 (1st Cir. 1987) (Breyer, J.) (applying New York law).

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