Negotiating Investment Banking Engagement Letters:

Avoiding Certain Traps for the Unwary Banker and Its Client

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TABLE OF CONTENTS

Page

I. INTRODUCTION.

One of the first steps most companies will take in connection with a potential capital raising or merger and acquisition transaction, or in connection with their consideration of a financial restructuring or their strategic alternatives generally, is the engagement of an investment banking firm. Too often, however, this important first step in a company's exploration of strategic or financial alternatives is viewed as a perfunctory exercise involving the execution of a largely standard form prescribed by the investment banking firm to which changes are rarely made. In fact, the failure to carefully review and tailor an investment banking engagement letter to the particular situation facing, and the specific goals of, the client company presents significant risks not only to the client company but also to the investment banking firm notwithstanding their carefully proscribed standard form. As this paper will illustrate, the failure to devote an adequate amount of time and energy upfront in negotiating and drafting specifically tailored engagement letters has the potential to create a situation in which each party's duties and obligations (*e.g.*, the specific advisory services to be performed or the fees to be paid) are not properly delineated.

It is imperative, therefore, that before entering into any investment banking engagement letter, the investment bank, its client and each of their respective counsel consider carefully the legal framework in which investment banking engagement letters are construed by the courts. There are special rules applicable to this area of contract law and they are not always well understood or considered; this paper will address some of the more commonly overlooked of those issues. The one issue this paper will not address is the indemnification section of investment banking engagement letters, as this is the one area that seems to always get attention by both parties, while other important and practically more significant sections are frequently overlooked. Instead, this paper will focus on (a) the necessity of the existence of a written agreement for the enforceability of the agreed-upon compensation, (b) the importance of carefully delineating the job the investment banker has actually been hired to accomplish and the corresponding question of whether that job involves services for which specific state-mandated licensing is required, (c) the clarity required in defining a successful "Transaction" which will result in the investment bank's entitlement to a fee, (d) the importance of agreeing to an exclusive versus a non-exclusive arrangement, (e) the issue of to whom the investment banker's duties are owed, and (f) special issues arising in the context of the approval of investment banking arrangements in bankruptcy, as well as general drafting considerations related to each of the foregoing.

II. THE REQUIREMENT OF A WRITTEN ENGAGEMENT LETTER

A. Overview of the Issues

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While the idea that a writing is required in order to enforce an otherwise agreed upon investment banking fee arrangement seems obvious to some, it is not always so obvious. First, in some states a writing, in fact, is not required. Indeed, the statute of frauds can differ from state to state. And the specific requirements for finder and brokerage arrangements can likewise differ from state to state. Moreover, depending on the particular services being rendered, the requirements for a writing can also differ even within states that require a writing for certain types of financial advisory, brokerage or finder services. In New York, for example, an agreement "to pay compensation for services rendered" in connection with "procuring an introduction to a party to" or "assisting in negotiation or consummation of" a transaction involving a "loan," the purchase of a "business," a "business opportunity," its assets or "the majority of the voting stock interest in a corporation," or the creation of a "partnership interest," is unenforceable unless it is in writing.[1] A "duly licensed real estate broker or real estate salesman," however, is exempted from this requirement in New York.[2] California law, however, is contrary because agreements authorizing or employing an agent, broker, or any other person to sell real estate, or to lease real estate for a period longer than one year fall within the California statute of frauds and therefore must be in writing in order to be enforceable.[3] Texas courts similarly require contracts involving the sale or other disposition of real estate to be in writing in order to be enforceable.[4] The Texas statute of frauds requirement also applies to "finder's agreements" that implicate the sale of real estate, and as such, they too must be in writing in order to be enforceable.[5] However, finder's agreements that do not implicate or otherwise involve a real estate component are not generally subject to this writing requirement.[6]

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[1] N.Y. GEN. OBLIG. L. § 5-701(a)(10).

[2] *Id*.

[3] CAL. CIV. CODE § 1624(a). Note, however, that the applicability of the California statute of frauds to investment bank engagement agreements will depend on an analysis similar to the one presented in Section III of this Article (*i.e.* will depend on how California law defines "broker" and "real estate" and whether these definitions mandate the application of the real estate statute of frauds standard articulated above). In sum, if the agreement is categorized as one implicating the requisite real estate component, the statute of frauds applies and such an agreement must be in writing in order to be enforceable. Conversely, if the agreement does not implicate the requisite real estate component, it is not subject to the statute of frauds and does not have to be in writing in order to be enforceable.

[4] *Lathem v. Kruse*, 290 S.W.3d 922, 925 (Tex. App.—Dallas 2009, no pet.) (holding that "[f]or an agreement or memorandum to pay a commission for sale or purchase of real estate to be valid the agreement (1) must be in writing and must be signed by the person to be charged with the commission, (2) must promise that a definite commission will be paid or must refer to a written commission schedule, (3) must state the name of the broker to whom the commission is to be paid and (4) must, either itself or by reference to some other writing, identify with reasonable certainty the land to be conveyed").

[5] *Swor v. Tapp Furniture Co.*, 146 S.W.3d 778, 782-83 (Tex. App.—Texarkana 2004, no pet.) (noting that an "[i]ntermediary failed to demonstrate that he was not employed to procure any real estate, precluding intermediary's recovery of a commission for introducing buyer of funeral home business to seller, where there was no written agreement between intermediary and seller, and intermediary was not a licensed real estate broker or salesperson; intermediary admitted in his deposition that all of the funeral home's assets, including real estate, were for sale.")

[6] *See BBQ Blues Tex., Ltd. v. Affiliated Bus. Brokers, Inc.*, 183 S.W.3d 543, 545-46 (Tex. App.—Dallas 2006, no pet.) (holding that "[o]ral commission agreement between business owners and brokers, which provided that owners

In New York, it is clear that, absent an express statutory exception to the statute of frauds, the "New York's statute of frauds applies to finders [including those serving customary investment banker roles] and their agreements to provide services, which means that finders must memorialize their agreements to find in writing in order for them to be enforceable."[7] While New York courts "distinguish between finders and brokers, [in which,] [f]inders find potential buyers or sellers, stimulate interest and bring parties together, while brokers bring the parties to an agreement on particular terms,"[8] outside of the real estate brokerage or real estate salesman context, finders and business opportunity brokers (*e.g.*, investment bankers and financial advisors) are generally treated the same under New York's statute of frauds, pursuant to which their engagement letters must be reduced to a writing to be enforceable.[9]

For example, in *Gutkowski v. Steinbrenner III*, a recent decision from the United States District Court for the Southern District of New York, the court ruled that a purported oral agreement between a marketer and the New York Yankees regarding the marketer's creation and development of a Yankees owned and operated television sports network (the "YES Network") was "unenforceable under New York's statute of frauds and therefore barred the plaintiff's breach of contract and quasi-contract claims."[10] This case involved a plaintiff who approached the Yankees in 1996 with the idea of creating the YES Network and, over the course of the next four years, advised the Yankees regarding the creation of the YES Network. On multiple occasions over the course of the plaintiff's purported engagement by the Yankees, the plaintiff alleged that the Yankees orally assured the plaintiff "that he would be compensated fairly for his efforts and that if, . . . the Yankees did create a network, the plaintiff would be the one to build it."[11] However, while the Yankees signed various separate consulting agreements with the

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would pay brokers a ten percent commission for finding purchasers for their business, did not contemplate a transfer of real estate, and therefore, was not unenforceable as a violation of the statute of frauds").

[7] *Futersak v. Perl*, 897 N.Y.S.2d 886 (N.Y. 2010) (holding that the finder of capital to fund a real estate venture was entitled to a fee because, among other things, he had a written finder's agreement with the defendant). However, "[a] duly licensed real estate broker or real estate salesman is explicitly exempted from [the statute of frauds] writing requirement when contracting to provide brokering services." *Id.* See also, N.Y. GEN. OBLIG. L. § 5-701(a)(10) (stating New York's statute of frauds "shall not apply to a contract to pay compensation to an auctioneer, an attorney at law, or a duly licensed real estate broker or real estate salesman").

[8] *Train v. Ardshiel Assocs, Inc.*, 635 F. Supp. 274, 279 (S.D.N.Y. 1986), *aff'd*, 805 F.2d 391 (2d Cir. 1986). Generally, finders must show that the consummated deal flowed directly from their introduction in order to be entitled to collect the finder's fee. *See generally, Seckendorff v. Halsey, Stuart & Co*., 234 A.D. 61 (1931), *rev'd on other grounds*, 182 N.E. 14 (N.Y. 1932). However, brokerage commissions ordinarily become due when the broker produces a party ready, willing and able to purchase on the terms authorized or accepted by the broker's client. *See generally, Bendell v. De Dominicis*, 251 N.Y. 305, 311 (1929).

[9] *See* N.Y. GEN. OBLIG. L. § 5-701(a)(10) (broadly defining services subject to the statute of frauds as procuring an introduction or assisting in the negotiation of a transaction); *Gutkowski v. Steinbrenner*, 680 F. Supp. 2d 602 (S.D.N.Y. 2010) (holding that services of a marketer, including the introduction to certain experts, are within the scope of the statute of frauds).

[10] *Gutkowski*, 680 F. Supp. 2d at 602.

[11] *Id*. at 605.

plaintiff over eight years during which the Yankees created a television network, the parties never reduced to writing the alleged oral engagement agreement that the plaintiff claimed was in effect regarding his involvement and compensation for being the architect of what became the YES Network. Although the plaintiff in *Gutkowski* argued that the services he provided to the Yankees went beyond the "services" contemplated by New York's statute of frauds, the court disagreed and ruled that the clear statutory definition of "negotiating" in the statute of frauds includes services similar to introducing parties to, or assisting in the negotiation and consummation of, a transaction – services which squarely fit within the customary description of those provided by an investment banker.[12] As a result, the oral engagement agreement between the plaintiff and the Yankees in which the plaintiff claimed he was due compensation as a result of the creation of the YES Network was ruled unenforceable under New York statutory law because, among other things, the agreement violated the statute of frauds.[13] Similarly, "[c]ourts interpreting [New York's statute of frauds] have generally held that where the transaction results in the acquisition of an existing enterprise or the formation of a new one, it is a business opportunity" within the scope of the statute of frauds and must be in writing in order to be enforceable.[14]

B. Drafting Considerations

As the foregoing overview clearly illustrates, there is great variation among the states with respect to the statute of frauds requirements and the specific agreements to which they apply or to which they are otherwise inapplicable. As such, the primary goal for investment bankers and their clients is to avoid these dizzying and often complicated set of rules, many of which are counter-intuitive. To accomplish this, two simple yet very crucial best practices must be strictly followed. First, as a rule, <u>always</u> make sure that all aspects of the engagement letter are memorialized in a writing properly executed by both parties and as early in the engagement as possible (preferable before the commencement of any official work). Second, <u>always</u> document any material or otherwise significant changes to the terms of the engagement in strict compliance with any formal amendment procedure(s) that may be set forth in the respective

[12] *Id*. at 613. *See also Snyder v. Bronfman*, 921 N.E.2d 567 (N.Y. 2009); *Freedman v. Chem. Constr. Corp*., 372 N.E.2d 12 (N.Y. 1977).

[13] *Gutkowski*, 680 F. Supp. 2d at 613. The *Gutkowski* court also ruled that the plaintiff's claim failed because (i) he did not adequately plead the compensation term of the alleged agreement, (ii) his claim for fraudulent inducement did not state a cause of action independent from the breach of contract claim and (iii) it was untimely under the statute of limitations.

[14] *Gutkowitz*, 680 F. Supp. 2d at 613. *See generally Mgmt. Recruiters of Boulder v. Nat'l Econ. Research Assocs. Inc.*, No. 02 Civ. 3507 (BSJ), 2006 WL 2109478 (S.D.N.Y. July 24, 2006). One important caveat here is that engagement agreements similar to those customarily executed by investment bankers in which services are provided to procure an introduction to a party or assist in the negotiation or consummation of a transaction must be distinguished from mere at-will employment agreements, which may not be within the general scope of the New York statute of frauds. For example, in *Nichols v. SG Partners, Inc*., No. 109439-09, 2010 WL 363268 (N.Y. Jan. 25, 2010), the plaintiffs sued to recover unpaid wages after being employed by defendant as placement professionals, earning both a base salary as well as a commission based on a percentage of defendant's revenues generated from placements that the plaintiffs made. The *Nichols* court ruled that "[b]ecause an at-will employment relationship may be freely terminated by either party at any time for any reason or even no reason, employment agreements of this type generally do not fall under the proscription of the [New York] Statute of Frauds."

agreement. The failure to abide by either of these two basic yet critical rules may render an engagement letter (or any amendments thereto) unenforceable.

III. INVESTMENT BANKERS AND STATE BROKER LICENSING REQUIREMENTS [15]

A. Investment Bankers as "Real Estate Brokers"

For investment banks, one rarely considered concern in the provision of advisory services to clients in the M&A context is the risk that some portion of such services may be considered "real estate brokerage" services requiring the investment bank to be licensed or registered as a real estate broker under applicable state law. The State of Florida provides one clear example of a state in which the services provided under a standard M&A engagement letter may require an investment banker to be licensed in the state as a real estate broker. Chapter 475 of the Florida Statutes defines "real estate" broadly, as both "real property" and "any interest in business enterprises or business opportunities," and requires that all "real estate" "brokers" be registered (if corporations) or licensed (if individuals) in order to conduct business in the state.[16] Further, Florida statutory and case law provide that "a contract with an unlicensed [real estate] broker [is] invalid."[17] The important consequence of this is that if a contract with a real estate broker (or an investment banker deemed to be a real estate broker pursuant to applicable state law) is held to be invalid, the counterparty is not required to pay the broker's commission.[18]

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[15] As a practical matter, parties to an engagement agreement and their respective counsel would be well-advised to scrutinize the services to be rendered pursuant to the engagement and the possible characterization of the subject interests that may be directly or indirectly implicated in connection therewith. This section of the paper exclusively deals with the scenario in which the interests implicated in the engagement agreement may be characterized as "real property" interests, thus triggering certain licensing and/or registration requirements pertaining to real estate brokerage services. Note, however, that certain other characterizations of the interests implicated by a typical investment bank engagement agreement may have certain consequences and require the application of drafting strategies and considerations outside the scope of the issues covered herein. For example, characterization of these interests as "securities" may render state and/or federal securities laws (including, but not limited to, certain additional and distinct broker requirements) applicable. In addition, certain states impose other additional requirements on the basis of how the transaction (or the interests implicated thereby) is characterized under applicable laws. For example, in addition to the broker licensing requirements discussed in this section, certain statements may separately require licensing/regulatory requirements in order to facilitate the sale of interests in a company. The foregoing issues are outside the scope of this section of the paper and the reader is hereby advised to consult the applicable law in the appropriate jurisdictions and to take such matters into consideration when negotiating and drafting investment bank engagement agreements.

[16] *See* FLA. STAT. §§ 475.01, 475.15, 475.17. *See also, Hannan v. City Fed. Sav. & Loan Ass'n*, 500 So. 2d 235, 235 (Fla. Dist. Ct. App. 1986) ("As of January 1, 1982, the definition of a real estate broker was amended to include business brokers."); *Meteor Motors, Inc. v. Thompson Halbach & Assoc.*, 914 So. 2d 479, 482 (Fla. Dist. Ct. App. 2005) (holding that a corporation "in the business of bringing together buyers and sellers of automobile dealerships" was a broker subject to regulation under Chapter 475 because "a closer reading of the statute demonstrates that it regulates business brokers without any connection to real estate").

[17] *Meteor Motors, Inc.*, 914 So. 2d at 481; FLA. STAT. § 475.41 ("No contract for a commission or compensation for any act or service enumerated in § 475.01(e) is valid unless the broker . . . has complied with this chapter in regard to issuance and renewal of the license at the time the act and service was performed.").

[18] *Id.* ("We hold that section 475.41 prevents the broker from enforcing its fee contract."); *Previews, Inc. v. Murff*, 502 So. 2d 1317, 1318 (Fla. Dist. Ct. App. 1987) ("Where one cooperating broker is under a disability to recover a

Because many traditional M&A related investment banking services are generally provided in connection with the marketing, acquisition or divestiture of an interest in business enterprises or business opportunities, or, more directly, involve transactions in which real property, or a company with interests in real property, is bought or sold, state statutes similar to those found in Florida may have the consequence of preventing investment bankers from collecting their negotiated fees if they are not licensed or registered as a real estate broker in the respective state. Accordingly, investment banks that are engaged to provide advisory services in connection with the sale of an interest in a business or real property are thus well-advised to be aware of the possible applicability of "real estate" provision(s) of the applicable state law that governs their transaction and obtain real estate licenses where appropriate or limit the scope of the offered services accordingly so as to circumvent the application of these licensing requirements.

As is the case with many state statutes, there is significant variation among states in the applicability of real estate laws (and related broker licensing requirements) to investment bank engagement letters. The following subsections highlight how Florida's facially unambiguous statute and case law compares to similar statutes in New York, Texas and Delaware.

B. New York

The regulations governing real estate brokers, and their potential applicability to investment bankers, under New York law do not appear on their face to be as inclusive as those in Florida; however, depending on the nature of the underlying transaction, investments bankers may fall subject to certain New York licensing requirements applicable to real estate brokers. New York Real Property Law § 442-d provides that "no person, co-partnership or corporation shall bring or maintain an action in any court of this state for the recovery of compensation for services rendered . . . in the buying, selling, exchanging, leasing, renting or negotiating a loan upon any real estate without . . . proving that such person was a duly licensed *real estate broker*."[19] The applicability of New York real estate law generally turns on a two step analytical framework employed by New York courts and consisting of (i) a threshold determination as to whether the subject transaction is one that involves the requisite real property component and (ii) a determination as to whether the engaged professional is actually functioning as a real estate broker.[20] Interestingly, a review of relevant case law indicates that New York courts also

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commission because of being non-registered, this infirmity affects the validity of the entire contract and no recovery is permitted.").

[19] NY RPP LAW 442-d (emphasis added).

[20] *See Futersak*, 897 N.Y.S.2d at 886 (noting that "[i]t is a prerequisite to section 442-d's application that there must be a transaction for real estate. Once this is established, the court must scrutinize the services involved to determine if there was a fiduciary-like duty and [whether] negotiations were performed at the behest of [a] principal").

attempt to display a certain level of restraint when determining the applicability of New York real estate principles to certain transactions.[21]

With respect to the first prong, New York law provides that a "real estate broker" is defined as "any person, firm, limited liability company or corporation, who, for another and for a fee, commission or other valuable consideration, lists for sale, sells, . . . exchanges, . . . or offers or attempts to negotiate a sale, exchange, [or] purchase of an . . . *interest in real estate*."[22] For the purposes of the definition of real estate broker, an "interest in real estate" includes the "sale of a business wherein the value of the real estate transferred as part of the business is not merely incidental to the transaction."[23] Although no recent[24] New York court has expressly addressed what relative real property value is required in order for it to not be "incidental to the transaction," it is fairly easy to imagine a transaction represented by an investment banker involving a merger, acquisition or divestiture of a company or group of assets that includes a real property component whose value (or relationship to the underlying business subject to the transaction)[25] could reasonably be determined to be more than incidental to the overall transaction.

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[21] *Id*. at 886. (noting that absent such restraint, the licensing requirement "would be unlimited and indiscriminately apply to many other participants routinely appearing in a real estate transaction who may not be licensed brokers….").

[22] NY RPP LAW 440 (emphasis added).

[23] *Id*. NY RPP LAW 440 does provide, however, that an "interest in real estate" shall not include (i) the assignment of a lease or (ii) where the transaction itself is subject to regulation under state or federal laws governing the sale of securities.

[24] For example, the court in *Weingast v. Rialto Pastry Shop,* 243 N.Y. 113 (1926) held that a party engaged in buying and selling places of business or going concerns, including the leases of the places in which the business is being conducted, is not a real-estate broker required to obtain a license in order to recover a commission under the New York statute because the term "real-estate broker" as defined by the applicable New York statute means any person, firm, or corporation, who, for commission or other valuable consideration, lists for sale an "interest in real estate." The court specifically noted that the foregoing language was not "broad enough to cover, or was not intended to cover, every transaction in which an interest in real estate may be part of the subject of transfer." In fact, the court particularly noted that the statute does not apply to one who is in the business of selling or exchanging businesses as going concerns, although, as part of the goodwill, such sales may include the lease of a store or building. The court went on to add that one who makes a specialty of procuring purchasers for restaurants, drugstores, grocery stores, and the like as going concerns, where a lease simply goes with the place as part of the goodwill, does not become, within the law, a real-estate broker. *See also Dodge v. Richmond*, 5 A.D.2d 593 (N.Y. App. Div. 1958) (holding that the mere inclusion of an item of real estate in a transaction involving the transfer of the assets of a business is not sufficient to bar an action for the recovery of a commission.)

[25] For example, in another case, *Sorice v. DuBois*, 25 A.D.2d 521 (N.Y. App. Div. 1966), a plaintiff sought to recover a fee based on the services that he rendered in connection with the sale of a hotel business located in New York and the defendant asserted several defenses, including that the plaintiff was not a licensed real estate broker or salesman and, therefore was not entitled to any fees. The court started its analysis by citing to the general rule regarding the inapplicability of licensing requirements where the real estate involved is a mere incident or incidental feature of the transaction. However, the court went on to note that "[i]f real estate is going to be the principal element involved in the transaction, a broker has to have a license and cannot evade its necessity by referring to the services as originating or introducing or any other fantastic term." Thereafter, the court concluded that in the transaction upon which the suit was based, real estate was indeed the principal element involved, and the dominant

The starting point for the second prong of the analysis noted above is generally the definition of who constitutes a "real estate broker" as such term is defined in New York Real Property Law Section 442-d. In addition to this statutory definition, and as noted above, New York courts also look for the existence of a fiduciary-like relationship and whether heightened transactional authority has been conferred on the engaged professional.[26] While there is very little case law expressly interpreting whether an investment banker is a "real estate broker" under New York law, a New York court recently addressed whether a company that engaged a financial advisor merely to introduce it to various capital sources for the purpose of funding the acquisition of real property lacks legal capacity to challenge such financial advisor's claim for recovery of a fee on the basis that the advisor was not a "duly licensed real estate broker."[27] The defendant company, in its motion to dismiss the financial advisor plaintiff's claim, argued that the financial advisor was essentially requesting a commission for the company's acquisition of real property and, thus, could not collect a fee without being a properly licensed real estate broker. The court rejected the defendant's argument, holding instead that the plaintiff had not listed for sale, sold, exchanged, bought or rented, or otherwise negotiated a sale of or purchased real estate or an interest in real estate – all actions necessary under the statute to require an individual to be a licensed real estate broker. In the judge's words, "[t]he court is at a loss as to how [the financial advisor] would be a "real estate broker" if it did not do any of the above, but, instead, only introduced [the defendant company] to various capital sources for the purpose of funding the acquisition of real estate properties."[28]

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feature of the transaction since "the business of operating a hotel is one that exploits the real estate and the sale involved is really the sale of real estate." Consequently, the court granted the defendant's motion for summary judgment thereby precluding the plaintiff's recovery.

[26] *Futersak*, 897 N.Y.S.2d at 894. (noting that examples of New York "precedents demonstrate that activities falling outside the scope of negotiation or a fiduciary-like duty weigh in favor of finding that the [New York] Real Property Law does not apply.").

[27] *Transaction Advisory Servs., LLC v. Silver Bar Holding, LLC*, 38 A.D.3d 241 (N.Y. App. Div. 2007). Similarly, even where the real estate is the principal subject matter of the transaction, a recent New York case held that "finders" services alone, which did not rise to the level of brokerage services involving negotiation of the deal, did not require a real estate license. *Futersak,* 897 N.Y.S.2d at 886. In another New York case, a court found New York's real estate licensing requirement inapplicable as a bar against an engaged professional's recovery of a fee for services rendered in connection with a transaction that incidentally involved a real property component. *See Eaton Assoc. v Highland Broad. Corp*., 81 A.D.2d 603 (N.Y. App. Div. 1981). In this case, the plaintiff was hired to prepare, present and market a refinancing package for the defendant, which owned and operated two radio stations. The plaintiff thereafter prepared a business plan which detailed market share, sales, cash flow and expenses for the defendant's use in connection with its dealings with potential lenders. As a result of plaintiff's services, the defendant client obtained first and second mortgage financing from certain lending institutions. When the plaintiff later brought suit to recover its fee for the services rendered, the defendant argued that it was barred from receiving a fee because it did not have a real estate license. The *Eaton* court rejected the defendant's argument, reasoning that the plaintiff's services, including the preparation of a financial plan and the rendering of financial advice to defendant's employees and officers, fell outside of the scope of brokerage services, and that the purposes of the real estate broker's licensing requirements would not be furthered by requiring compliance from a financial consultant such as the plaintiff. *Id*. at 604.

[28] *Transaction Advisory Serv.,* 38 A.D.3d at 5.

Notwithstanding the foregoing, it may be difficult to garner a clear opinion of how New York courts will treat an investment banker engaged in connection with a transaction that actually includes a significant real estate component. Accordingly, investment bankers providing services in New York need to be cautious about the likelihood that a client could argue against its entitlement to a commission because the investment bank was not a licensed real estate broker when engaged in a transaction involving a significant real property component.

C. Texas

Investment bankers engaged in transactions in which Texas law is implicated may not have the same concerns about triggering real estate broker licensing requirements as in Florida or New York. Although Chapter 1101 of the Texas Occupations Code, which governs real estate brokers and salespersons, requires real estate brokers to be licensed, the statutory definitions of "broker" and "real estate" are much more limited than that of Florida and New York.[29] While the applicable Texas statute does provide that "[r]eal estate" means "any interest in real property, including a leasehold, located in or outside this state," unlike Florida or New York, the Texas statute's definition of real estate does not directly encompass transactions involving the sale of a business, business enterprises or business opportunities.[30]

Although there is very little case law on point specifically addressing the issue of whether financial advisors are considered real estate brokers in Texas for purposes of determining the applicability of Texas broker licensing requirements, the plain language of the statute suggests that this is not the case. In *Gamble v. Norton*, the Court of Appeals of Texas, Houston division held that a licensed real estate broker is not subject to the statute governing real estate brokers for acts such as selling, managing, and investing in joint ventures merely because such business opportunities may involve real property.[31] However, the *Gamble* court's holding

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[29] *See* TEX. OCC. CODE ANN. § 1101.351; TEX. OCC. CODE ANN. § 1101.002. Specifically with respect to a real estate broker, the statute provides:

> (1) "Broker": (A) means a person who, in exchange for a commission or other valuable consideration or with the expectation of receiving a commission or other valuable consideration, performs for another person one of the following acts: (i) sells, exchanges, purchases, or leases real estate; (ii) offers to sell, exchange, purchase, or lease real estate; (iii) negotiates or attempts to negotiate the listing, sale, exchange, purchase, or lease of real estate; (iv) lists or offers, attempts, or agrees to list real estate for sale, lease, or exchange; (v) appraises or offers, attempts, or agrees to appraise real estate; (vi) auctions or offers, attempts, or agrees to auction real estate; (vii) deals in options on real estate, including buying, selling, or offering to buy or sell options on real estate; (viii) aids or offers or attempts to aid in locating or obtaining real estate for purchase or lease; (ix) procures or assists in procuring a prospect to effect the sale, exchange, or lease of real estate; or (x) procures or assists in procuring property to effect the sale, exchange, or lease of real estate; and (B) includes a person who: (i) is employed by or for an owner of real estate to sell any portion of the real estate; or (ii) engages in the business of charging an advance fee or contracting to collect a fee under a contract that requires the person primarily to promote the sale of real estate by: (a) listing the real estate in a publication primarily used for listing real estate; or (b) referring information about the real estate to brokers.

[30] TEX. OCC. CODE ANN. § 1101.002. The Texas statute also provides that "[t]he term [real estate] does not include an interest given as security for the performance of an obligation."

[31] *Gamble v. Norton*, 893 S.W.2d 129 (Tex. App.—Houston [1st Dist.] 1995, no writ) (involving the issue of whether a party can recover from the [Real Estate Recovery Fund] for acts committed by a real estate broker while the broker was acting as a manager and principal of an investment venture).

ultimately turned on the fact that the real estate broker acted as a principal rather than an agent in the transaction by taking title to the joint venture properties in his own name instead of the partnership's. Thus, while the plain language of the Texas statute is quite narrow, it is nonetheless wise for investment bankers and their clients to keep in mind that the case law is not well settled. As such, the statutory language cited above, in addition to the sparse case law on point, may lead to unpredictable results in a scenario where Texas law governs the services to be provided under an engagement letter and those services entail, in some shape or form (either directly or indirectly), the sale, encumbrance, disposition or other transfer of real property.

D. Delaware

Similar to the Texas statute, Chapter 29 of Title 24 of the Delaware Code on Professions and Occupations, which governs real estate brokers and other salespersons, provides a restrictive definition of "broker" or "real estate broker" and is not, on its face, inclusive of the broader provisions found in states such as Florida regarding the sale of a business, business enterprises or business opportunities.[32] While Delaware courts have held that failure to comply with the licensing requirements of the Delaware Code related to real estate brokers[33] renders real estate contracts unenforceable, Delaware courts interpret the applicability of the statute relatively narrowly.[34] For example, in *Bellanca Corp. v. Bellanca*, the Supreme Court of Delaware affirmed that single transactions of brokerage services involving real property are not governed by the statute.[35] The court reasoned that because the definition of "real estate broker" in the Delaware Code encompasses individuals who engage in real estate brokerage as a "full or part time vocation," unlicensed persons may be still compensated for acting as a broker in the sale of real property where the sale is a single, isolated transaction.[36] Thus, while Delaware courts have yet to address the specific issue concerning the enforceability of an investment bank engagement letter where the investment banker party thereto is not licensed as a real estate broker in the state,

[32] 24 DEL. CODE ANN. § 2901. Specifically, Section 2501 of the statute provides the following definition:

> "Real estate broker" or "broker" means any person who holds a broker's certificate from the commission and who, for a compensation or valuable consideration, is self-employed or is employed, either directly or indirectly by a broker owner, broker of record, or brokerage organization to sell or offer to sell, or to buy or to offer to buy, or to negotiate the purchase, sale, or exchange of real estate or to lease or rent or offer for rent any real estate, or to negotiate leases or rental agreements thereof or of the improvements thereon, as a whole or partial vocation. This definition shall not apply to an ''auctioneer'' as that term is defined in § 2301(a)(3) of Title 30.

[33] DEL. CODE ANN. TIT. 24 § 2906 provides "[n]o person, partnership, association or corporation shall act as a real estate broker or real estate salesperson, or advertise or assume to act as such real estate broker or real estate salesperson without being registered and without a certificate of registration issued by the Commission."

[34] *See E. A. Strout Co. v. Howell*, 85 A. 666 (Del. 1913) (holding that a contract between a seller of land and a foreign corporation unlicensed as a real estate agency that maintained an active, on-going real estate business in Delaware was unenforceable because the broker had not complied with the state's licensing requirements), *but see Bellanca Corp. v. Bellanca*, 169 A.2d 620 (Del. 1961) (holding that contract governing a single transaction for the sale of real property by an unlicensed broker may be enforceable).

[35] *Bellanca Corp.*, 169 A.2d at 626.

[36] *Id.*; *See also Stoltz v. Del. Real Estate Comm'n*, 473 A.2d 1258 (Del. Super. Ct. 1984.); *Coyle v. Peoples*, 349 A.2d 870 (Del. Super. Ct. 1975), *aff'd*, 372 A.2d 539 (Del. 1977).

holdings like those in *Bellanca Corp. v. Bellanca* seem to indicate that an unlicensed investment banker may still be able to enforce its engagement letter with respect to a transaction involving real property if providing real estate brokerage services is not the investment banker's full or part time vocation. Although the narrow scope of the Delaware statutory provisions and the cases noted above suggest that investment bankers may not have to be concerned about the broker licensing requirements in Delaware, it is important for investment bankers, their clients and their respective counsel to be mindful of this possibility when the services to be rendered pursuant to an engagement letter governed by Delaware law are in some way connected to the sale or other transfer of real property.

E. Drafting Considerations

The foregoing analysis of just a few selected states' laws illustrates the oft-overlooked issue of the impact state brokerage license requirements may have on an investment banker's ability to recover fees pursuant to an engagement letter. Therefore, while in general it is not likely that investment bankers will be prohibited from collecting fees pursuant to an engagement letter as a result of being classified real estate brokers, it is nonetheless important to be mindful of the specific requirements of each applicable state's laws before negotiating and executing engagement letters with potential clients. Below is a non-exhaustive list of practical considerations relevant to the drafting and negotiation of investment bank engagement letters in light of the possibility of an investment banker being deemed a real estate broker under applicable state law:

- <u>Choice-of-law provisions in engagement letters</u>. To the extent possible, under applicable conflict of laws principles,[37] choose a state law to govern the contractual relationship between the investment bank and its client that most clearly establishes the non-applicability of state real estate broker licensing requirements with respect to the subject transaction or investment banker. It is not clear, however, that by simply choosing a law to govern the engagement letter that does not implicate any real estate licensing requirements that the investment bank is not nevertheless subject to another state's licensing requirements if the principal subject matter of the M&A engagement is a business or asset located in a state with such licensing requirements.[38]

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[37] Although some states (*e.g.*, Florida) have not adopted the Restatement (Second) Conflict of Laws (1971), many of such states internal conflict of laws provisions are similar to the Restatement. Section 187 of the Restatement (Second) Conflict of Laws (1971) states that a court may find a choice-of-law provision does not apply where either (1) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice or (2) application of the law of the chosen state would be contrary to the fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the Restatement, would be the state of the applicable law in the absence of an effective choice of law by the parties.

[38] Courts in states like Florida "are required to enforce choice of law provisions in contracts unless the law of the foreign state contravenes the strong public policy or is unjust or unreasonable." *See generally Default Proof Credit Card Sys., Inc. v. Friedland*, 992 So. 2d 442 (Fl. Ct. App. 2008). *See e.g. Meteor Motors, Inc.*, 914 So. 2d at 482 (holding that Florida's real estate broker licensing requirement was applicable to a "[b]usiness broker located in another state [who] conducted brokerage activity within the state by finding a buyer for the stock of an automobile dealership located within the state, and thus statute invalidating contracts for the payment of a commission to an unlicensed broker applied to broker, even though broker used telephone and e-mail to contact potential buyers;

- Determine the value of any real property related to a transaction subject to an engagement letter. If an transaction that is subject to an engagement letter implicates New York law, it may be important to conduct a valuation analysis on any real property connected to the transaction in order to determine if the value of such real property is "not merely incidental to the transaction." Although New York law does not provide substantial guidance in making such determination, if the value of any real property is "not merely incidental to the transaction," it is possible that in a subsequent dispute regarding the investment bank's entitlement to a fee, the client may argue that the investment bank is prohibited from collecting a fee if it is not a licensed real estate broker.

- Include an express severability provision. As noted in the discussion above, one possible consequence of the application of real estate broker licensing requirements is that an unlicensed investment banker may not be able to recover its fees. In some jurisdictions, courts have held that where an investment bank engagement letter involves the disposition of real estate (in some cases irrespective of whether such disposition is direct or indirect) in the context of a larger transaction along with other interests, such agreement may be severable such than an unlicensed real estate broker may recover the components of the applicable fees attributable to the non-real estate aspects of the transaction. As such, as an added safeguard, parties to an engagement letter governed by the law of a potentially problematic jurisdiction should insert a provision in the agreement that expressly incorporates this severability concept.[39]

- Limit services to that of a finder. In a M&A transaction involving real estate, many of the services offered by a financial advisor are similar to that offered by a real estate broker. But some states, including New York, exempt "finders" from the real estate licensing requirements. Consider limiting the investment bank's services so that they do not include actual negotiation and consummation of the Transaction to avoid coming within the definition of a "broker" in the applicable state. For example, in New York a "finder" is a person who simply "brings the parties together, but without any obligation or power to negotiate the transaction," whereas a "broker" "bargains or

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broker solicited potential buyers within the state, and the eventual buyer was a corporation based in the state."). This case clearly indicates that even where the parties have selected a state law to govern their engagement agreement, such determination may not be dispositive and will certainly not guarantee the circumvention of any applicable licensing requirement(s).

[39] Please note, however, that certain jurisdictions have rejected this severability argument (or conditioned its applicability on whether the documentation evidencing the transaction reflects a itemization of its core real estate and non-real estate components) and, as a result, such a provision may be deemed unenforceable in these jurisdictions. *See, e.g., Anderson v. Republic Nat'l Life Ins. Co.*, 623 S.W.2d 162 (Tex. App.—Fort Worth 1981, no writ) (holding that a transaction consisting of the sale of a business was not divisible and had to be viewed as one single transaction involving the sale of real estate, where the price provided in the closing documents showed no allocation or distinction between the real estate components and the actual business).

carries on negotiations on behalf of his principal as an intermediary between the latter and third persons."[40]

IV. ARTICULATING & DRAFTING CLEAR AND PRECISE INVESTMENT BANK PERFORMANCE OBLIGATIONS

As alluded to at the onset of this paper, one of the key negotiating and drafting objectives associated with investment banking engagement letters is ensuring that the parties' respective performance duties, rights and obligations are clearly and unambiguously set forth within the four corners of the agreement. In this regard, there are three issues that often take center stage given their significance and the frequency in which they are involved in disputes between investment banks and their clients: (a) the definition of the underlying "Transaction" that is the subject of the engagement, (b) the concept of an exclusive versus non-exclusive engagement (and the related concept of "procuring cause") and (c) the terms of the engagement letter's fee structure addressing when, and in what amounts, an investment banker is entitled to receive a success fee for work under the agreement.

A. Precisely Defining the Scope of a "Transaction"

As is often the case in standard investment bank engagement letters, an investment banker typically is only entitled to receive a fee, and the client is only required to pay a fee, concurrent with, or upon consummation of, a particular type of "Transaction" (or however such similarly used word is defined in the respective engagement letter). For example, a corporate client may engage a financial advisor to specifically facilitate "a capital raise to fund the repurchase or paydown of a portion of the company's outstanding debt" or "the divestiture of certain assets of the company" and only upon the consummation of such event(s) is the payment obligation of the client triggered. As a result, from the perspective of both the investment bank and the client, the interpretation of what constitutes the defined Transaction in a particular engagement letter is of the highest importance.

Well-established law provides that the intent of the parties to a contract "is to be inferred, if possible, solely from the written provisions of the contract [and] [t]he clear and explicit meaning of these provisions, interpreted in their ordinary and popular sense, unless used by the parties in a technical sense or a special meaning is given to them by usage, controls

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[40] *See Futersak,* 897 N.Y.S.2d at 891. In this case, the court specifically noted that the services performed by a plaintiff seeking the recovery of a finder's fee were those of a finder and do not come within the ambit of the licensing requirements set forth in section 442-d of the Real Property Law. The *Futersak* court specifically noted that a review of the facts in the case weighed in favor of the foregoing conclusion because, *inter alia*, (a) the written agreement between the parties (which was drafted by defendant client), explicitly refers to plaintiff being compensated in the role of a finder, (b) there was nothing in the agreement, explicit or implied, authorizing the plaintiff to act as the defendant's agent in the actual or functional meaning of that term and relationship, (c) the plaintiff had no explicit or implied power to bind defendants, and (d) the plaintiff did not have the power to negotiate the transaction. In sum, the *Futersak* court concluded that the plaintiff did not have the power to do anything except find and introduce prospects and, accordingly was not a broker, but rather a finder and therefore not subject to the licensing requirements and its related restrictions. *Id.*

judicial interpretation."[41] Moreover, courts generally view business terms in contracts between sophisticated parties as unambiguous language. For example, a New York court concluded that "[t]here is nothing ambiguous about the term 'equity securities'" or "securities convertible into or exchangeable for equity securities" when used in an engagement letter.[42] The court noted in this case that although the agreement in question did not define these terms, the contracting parties were sophisticated and assumed to have intended to use the generally accepted business definitions in their drafting of the agreement.[43] Thus, sophisticated contracting parties may be imputed with the knowledge of generally accepted business definitions. As a result, unless otherwise expressly specified in the engagement letter, using such business terms implies an intent to use the accepted definitions.[44] As such, when parties to an engagement letter intend for a term to have a meaning other than such term's commonly accepted business definition, it is imperative that the meaning of such term be expressly spelled out in the agreement through the use of specifically negotiated and properly defined terms.

From the client's perspective, it is important to limit the definition of "Transaction" to the transaction it actually hopes to accomplish and for which it believes it has specifically engaged the investment bank, particularly when there will typically be a "tail" period during which the bank will be entitled to a fee on a concluded transaction coming within the definition of "Transaction" even after an unsuccessful effort to conclude the originally contemplated transaction. One recent New York case involved an engagement letter that defined a "Transaction" to include, among other specifically enumerated types of transactions, any placement of private or public equity, any issuance of senior debt, any issuance of mortgage financing or any merger.[45] The client plaintiff sought to restrict the definition of a "Transaction" pursuant to which the investment bank could recover a fee to the specific transaction it had presumably intended, *i.e.*, "a large, 'roll-up' type transaction whereby [the client plaintiff] would 'roll-up' its existing projects . . . into a single holding company."[46] However, because the plain language of the agreement did not in any way limit the scope of "Transactions" upon which the investment bank could recover a fee, the court refused to narrow the definition of "Transaction."[47]

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[41] *Great W. Drywall, Inc. v. Interstate Fire & Cas. Co.*, 161 Cal. App. 4th 1033, 1040 (2008); *see generally ABS P'ship v. AirTran Airways, Inc.*, 1 A.D. 3d 24, 29 (N.Y. App. Div. 2003); *Bethlehem Steel Co. v. Turner Constr. Co.*, 2 N.Y.2d 456, 460 (1957).

[42] *Crowley v. VisionMaker, LLC*, 512 F. Supp. 2d 144, 152-153 (S.D.N.Y. 2007).

[43] *Id*.

[44] *See generally Iconoclast Advisers LLC v. Petro-Suisse Ltd.*, ___N.Y.S.2d ___, 2010 WL 2218406 (N.Y. May 14, 2010) (stating "[t]hese parties were sophisticated business persons, negotiating at arm's length, and are bound by the unambiguous agreement that they entered into").

[45] *Mercury Partners LLC v. Pac. Med. Bldgs., L.P.*, No. 02 CIV 6005 HBP, 2007 U.S. Dist. LEXIS 55855, at *29-31 (S.D.N.Y. July 30, 2007).

[46] *Id.* at *19.

[47] *Id.* at *36.

Just as a court is reluctant to narrow the definition of "Transaction" as expressed in the written engagement letter for the benefit of the client, it will also generally not broaden the parties' negotiated language for the benefit of the investment bank either. In *Iconoclast Advisers LLC*, a recent New York case, an investment banker was "engaged to render financial advisory and investment banking services to the company solely in connection with: (a) the possible acquisition, merger, consolidation, asset purchase, reorganization or other business combination with the Target involving all or a portion of the business, assets or stock of the Target . . . or (b) the acquisition of effective control over the business affairs of any of the Target's businesses through a management services agreement or similar arrangement."[48] After the consummation of a transaction between affiliates of the company that was actually a party to the engagement letter and the Target, but not the actual named party, a dispute arose over payment of the fee provided for in the engagement letter. The court in *Iconoclast Advisers LLC* noted that the unambiguous definition of "Transaction" was meant to describe a " 'targeted retention' for a specific transaction between the parties named" and had the parties "intended to make the [Transaction] apply to the specifically named parties *and affiliated parties*, they could have negotiated and included such a particularized provision …."[49] Consequently, the court did not allow the inclusion of affiliates in the definition of "Transaction" under the engagement letter and the investment banker was denied recovery of a fee for the transaction actually consummated."[50]

B. Entitlement to a Fee with or without Being the "Procuring Cause" of the Transaction: Exclusive versus Non-Exclusive Engagement

Many standard engagement letters provide that the investment bank's retention is "exclusive." While this has obvious effects on whether the engaging client is entitled to engage other banks to assist with the "Transaction," the existence of such exclusivity has also been a critical component of an investment bank's entitlement to a fee when it was not directly involved in procuring the "Transaction." Generally, courts are more likely to find that a fee was earned by the investment bank upon consummation of a transaction under an exclusive agreement irrespective of whether they actually brought about the desired result.[51]

One such example is found in *Deutsche Bank Securities, Inc. v. Rhodes* in which an investment bank was engaged on an exclusive basis to provide investment banking advisory services in furtherance of a company's efforts to obtain certain financing.[52] The exclusive nature of this engagement was spelled out in a provision contained in an addendum to the engagement letter that read "[t]he Company hereby retains DBSI on an exclusive basis until the earlier of (x) one year from the date hereof and (ii) the date that the company and [the investment bank]

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[48] *Iconoclast Advisers*, 2010 WL 2218406, at *2.

[49] *Id.* at *6 (emphasis added).

[50] *Id.* at *7.

[51] *See generally Deutsche Bank Sec., Inc. v. Rhodes*, 578 F. Supp. 2d 652 (S.D.N.Y. 2008).

[52] *Id.* at 656.

reasonably determine that the closing of the facilities cannot be consummated within such one year period because of adverse market conditions."[53] After the client obtained financing with the assistance of another investment banking firm in breach of the exclusivity provision of the agreement, the engaged investment bank sought to recover the fee specified in the engagement letter. The court held that the proper interpretation of the engagement letter was that if the client breached the agreement by using the services of another investment banking firm, then the investment bank would be paid nonetheless. [54]

The court in *Deutsche Bank Securities, Inc.* noted that it is customary in the investment banking industry for investment banks to be contractually entitled to fees even when they do not arrange or facilitate the consummated transactions absent express contract language to the contrary. But in the absence of an exclusivity provision, it is important that there be specific language making it clear that the investment bank is not required to be the "procuring cause" of a "Transaction." For instance, the United States District Court for the Southern District of New York held in *CIBC World Markets Corp. v. Techtrader, Inc.* that a clause providing that an investment bank is entitled to a transaction fee during a certain period if "a Transaction is consummated or an agreement is entered into that subsequently results in a Transaction," entitled the investment bank to a fee without the requirement that it take any action at all in furtherance of the consummation of such transaction.[55] The court in *CIBC World Markets Corp.* noted that all that must occur under the agreement for the investment bank to earn its fee is that a qualifying transaction be "consummated" or "entered into" by the company.[56]

When an engagement letter is expressly non-exclusive and does not otherwise provide for the payment of a fee notwithstanding the investment bank's non-involvement in the transaction, however, it is possible that a court may borrow from the "open listing" versus "exclusive listing" concepts applicable to real estate brokers and require the banker to be a "procuring cause" of the "Transaction" in a non-exclusive engagement letter in order to recover its fee.[57] Although most case law dealing with open/non-exclusive agreements arises in the real estate rather than business brokerage context, as the Ninth Circuit has recognized, the "procuring cause" concept is not limited to real estate transactions, but is also applicable in other situations where a broker (which can fairly describe an investment banker's role in many M&A transactions) claims entitlement to a commission.[58] Although Texas, Delaware and New York

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[53] *Id.* at 657.

[54] *Id.* at 657.

[55] *CIBC World Mkts. Corp. v. TechTrader, Inc.*, 183 F. Supp. 2d 605, 612 (S.D.N.Y. 2001).

[56] *Id.*

[57] *See generally* CAL. CIV. CODE § 1086(f)(3) (1988) ("An 'open listing' is a listing which grants no exclusive rights or priorities to the listing agent, and a commission is payable to the agent only if the agent procures and presents to the owner an enforceable offer from a ready, able, and willing buyer on the terms authorized by the listing or accepted by the owner, before the property is otherwise sold either through another agent or by the owner directly and before the listing expires by its terms or is revoked.").

[58] *See Total Coverage, Inc. v. Cendant Settlement Servs. Group, Inc.*, 252 Fed. App'x 123, 124 n.2 (9th Cir. 2007) (citing *Chamberlain v. Abeles*, 88 Cal. App. 2d 291, 295-96 (1948)).

lack case law directly on point addressing the procuring cause concept in non-real estate investment bank engagement letters, if courts in any of these jurisdictions follow the Ninth Circuit in potentially applying the "procuring cause" concept to "non-exclusive" or "open" M&A engagement letters outside the real estate broker context (*i.e.*, the business brokerage context), the pressure on having clear language entitling the banker to a fee regardless of who was the "procuring cause" becomes even more critical. The "procuring cause" concept requires that in order to be entitled to a commission triggered by a sale of property, a broker must not only be the one who "finds a purchaser [or seller] who is ready, willing, and able to buy [or sell] the property on the terms stated …[but must also be the one who] obtains a valid contract obligating the purchaser [or seller] on these terms."[59]

C. Clearly Establishing the Investment Banker's Fee Structure

Of major importance to both the corporate client and the engaged investment bank are the issues related to when the client is required to compensate the investment bank for work performed under the engagement letter and how the amounts of such fees are to be calculated. Compensation paid to an investment banker pursuant to an engagement letter typically involves three different types of fees: out-of-pocket expenses, non-refundable retainers or deposits and success fees for successfully performing or completing the "Transaction."

While it is common for engagement letters to provide that the engaging client must pay for or reimburse the investment bank for the out-of-pocket expenses it incurs while pursuing the client's transaction, it is important to clearly define the scope of reimbursable expenses and whether (and to what extent) the client will have control over the investment banker's incurrence of such expenses. Depending on the scope of the services to be performed by the investment bank, it may be appropriate for the client to require that the investment banker obtain prior written approval for expenses above a certain threshold or in excess of an aggregate total amount – with any such unapproved expenses not being reimbursable. Not only does such a mechanism provide a level of control and protection to the engaging client in the event the

[59] *Phillippe v. Shapell Indus.*, 743 P.2d 1279, 1263 n.11 (Cal. 1987); *see Nelson v. Mayer*, 265 P.2d 52, 56 (Cal. Ct. App. 1954) (stating that an "[Agent], in order to recover commission, was required to produce before [principal] a purchaser ready, willing and able to purchase at the price and on the terms specifically expressed in the contract of employment [and]. . . . [T]he evidence must show that [agent's] efforts were the procuring cause of the sale and not merely one in a chain of causes."); *accord Estate of Ross v. Uhler*, 101 Cal. App. 3d 895, 900 (Cal. Ct. App. 1980) (stating that an "[A] sale involving an open listing agreement requires that the broker prove that the sale was the direct and proximate result of her efforts in order to obtain a commission."); *Air Conditioning, Inc. v. Harrision-Wilson-Pearson*, 253 S.W.2d 422 (Tex. 1952) (holding that in order to recover commission for a sale of realty, a broker must show that the services rendered by them constituted the procuring cause of the sale); *Nepa v. Marta*, 348 A.2d 182 (Del. 1975) (noting that the general rule is that a broker marketing a real estate interest may recover a commission only when he is the procuring cause of a consummated transaction); *Stoltz Realty Co. v. Paul*, No. Civ. A. 94C-02-208, 1995 WL 654152 (Del. Super. Ct. Sept. 20, 1995) (noting that "[t]he legal principles governing a [real estate] broker's right to commission are well settled. A broker may not recover commissions unless the broker is the procuring cause of the consummated transaction"); *B-H, Inc. v. Indus. Am., Inc.*, 253 A.2d 209, 214 (Del. 1969) (to be considered a procuring cause, the broker must establish that it was "the first link in a direct chain of causation leading to the consummation of the transaction, without a substantial break in the negotiations."); *Brandenberg v. Waters Place Assocs., L.P.*, 17 A.D.3d 615 (N.Y. App. Div. 2005) (stating that "a [real estate] broker must establish that he or she is duly licensed, that he or she has a contract . . . with the party charged with paying the commission, and that he or she has been the procuring cause of the sale or lease.").

engagement becomes more complicated and time-consuming than originally anticipated, but it may lessen the chance of a dispute or strain on the relationship between the parties that may otherwise occur if the investment bank submits a reimbursement claim for expenses that the client feels are excessive or needlessly incurred.

Of more significance to the parties to an engagement letter, however, is the payment of a success fee to the investment banker. The principal source of compensation for the investment banker is usually a fee earned for successfully completing the defined "Transaction." While there are many different types of success-fee structures, they are most commonly calculated as a percentage of the value of the consideration paid or received in connection with the transaction. It is also not uncommon to establish minimum and maximum success fees that may be earned in the engagement letter. Additionally, progressive fee schedules are sometimes employed in which the investment banker may receive an incrementally higher fee as the value of the transaction moves higher due to increases in bids from third parties participating in the auction process facilitated by the investment banker. Often progressive fee schedules are favored by corporate clients because they incentivize the investment banker and align the parties' interests in attaining the highest possible transaction value. However, contractual language regarding when a success fee is earned and the amount due is often the subject of differing opinions (which can lead to disputes) among the parties. As such, it is imperative that the express terms of the engagement letter clearly reflect the parties' intent as to the following (among other relevant factors): (a) when is a success earned and by whom, (b) when is such a fee payable, (c) the methodology to be used to calculate the fees and (d) the frequency of a payment (*i.e.*, depending on the nature of the transaction, may the fee be earned more than once for multiple transactions or is the fee a one-time payment).

One recent example of the conflict that can arise in the calculation and payment of fees pursuant to an engagement letter that the parties originally considered clearly-drafted and fully-negotiated is evidenced in the Australian case of *JP Morgan Australia Limited v. Consolidated Mineral Limited*.[60] The *Consolidated Mineral* case centered around the court's interpretation of certain fee provisions in an engagement letter pursuant to which JP Morgan was hired to advise the company concerning (and potentially defend against) possible takeover offers from third parties. Under the agreement, JP Morgan would earn a fee in the event that an offer for Consolidated Mineral was completed or successfully defended.

During the course of JP Morgan's 18-month engagement, Consolidated Mineral received multiple competing takeover bids from two primary third parties (Pallinghurst Resources LLP and Palmary Enterprises (Australia) Pty Limited), with Palmary's bid of $5 per share eventually succeeding. At the close of transaction, JP Morgan submitted an invoice to Consolidated Mineral for success fees totaling just over $50 million. Consolidated Mineral disputed the fee calculations and remitted payment to JP Morgan for $20 million. The basis of the dispute involved the defined term "defence response fee," which included two components: an "incentive fee," determined by the increase in the "offer price" above the "initial offer price,"

[60] *JP Morgan Australia Ltd. v. Consol. Mineral's Ltd*, [2010] NSWSC 100 (March 18, 2010).

and a "base fee," determined as a percentage of "Transaction Value," which was defined as the "total proceeds and other consideration paid…in connection with the offer."[61]

Regarding the determination of the incentive fee component, the court in *Consolidated Mineral* ruled that the fee should be calculated by reference to the difference between the final offer price under the consummated Palmary bid ($5) and Palmary's initial bid price ($3.95) and ***not*** from the initial offer price from ***any other bidder*** (which was approximately $2) since the court interpreted the fee clause to refer to the increase, if any, in a ***successful offer*** made ***by the same person*** (and not by reference to other (possibly) lower initial bids from unsuccessful bidders).[62] Since the engagement letter incentive fee provision did not expressly define what constitutes an "initial offer price" or establish that such "initial offer price" includes initial offers from parties that are not the ultimate winning bidders, the court justified its ruling as representing the "underlying commercial purpose of the engagement" of JP Morgan and the intent of the parties at the time engagement letter was executed.[63]

With respect to determination of the base fee (which was a percentage of the "Transaction Value"), the court further limited JP Morgan's recovery based on a narrow interpretation of what constituted the "total proceeds and other consideration paid…in connection with the offer." Palmary built up a substantial pre-closing stake in Consolidated Material prior to the consummation of the ultimate acquisition by buying shares of Consolidated Material from other third parties; however, the court ruled that while Palmary's pre-bid stake was "acquired in anticiption of a takeover offer," the stake was not purchased "in connection with the offer" that resulted in the consumated takeover.[64] Additionally, the court ruled that the net debt of Consolidated Material at the time of the closing of the takeover was not part of the "total proceeds and other consideration paid" and should not be included in the calculation of the base fee due JP Morgan.[65] While the engagement letter expressly referred to "net debt" as a type of potential consideration that may be paid in connection with the takeover (and, in such event, included in the calculation of the base fee), the court ruled that such a reference was meant to only cover transactions in which the buyer explicitly agreed to assume the burden of Consolidated Material's net debt as part of its consideration. Although Palmary effectively purchased the stock of the Consolidated Material in the transaction (thereby indirectly assuming its liablities, including, its net debt obligations), the consideration paid during the takeover did not ***expressly*** include the assumption of company's net debt and therefore it was determined not to be "other consideration paid" for the purposes of calculating the base fee under the engagement letter.[66] The court refused to read into the engagement letter the concept that the

[61] *Id.* at ¶ 6.

[62] *Id.* at ¶ 83-89 (emphasis added).

[63] *Id.* at ¶ 107.

[64] *Id.* at ¶ 83-84.

[65] *Id.* at ¶ 95.

[66] *Id.*

company's enterprise value should be used for determining the compensation paid by the buyer. Lastly, the court ruled that JP Morgan was not entitled to separate "defence response fees" based on rejection of the other, non-winning bids that were submitted for Consolidated Material. The court ruled that a "successful defence" (which would have garnered a fee under the agreement) does not include the rejection of, or non-acceptance by, the shareholders of Consolidated Material when a better offer was accepted in its place.[67]

As previously mentioned, it is also important to clearly articulate whether an investment banker is entitled to earn a fee (*i.e.*, one-time for a consummated transaction fee or multiple times in a series of transactions) and when such right to a fee is terminated. As highlighted in *In re Oneida Ltd*., a recent decision from the United States Bankruptcy Court for the Southern District of New York, unclear drafting and ambiguous actions taken by the parties can lead to a dispute concerning the manner in which the engagement agreement may be terminated and the resulting frequency in which an investment banker is entitled to earn a fee.[68] In this case, Oneida engaged, and subsequently paid a success fee to, an investment banker for assistance in a financial restructuring that was consummated in August 2004. While the investment banker did not provide any further services to Oneida after August 2004, the engagement agreement contained a fee tail that would have entitled Oneida to a second fee for certain subsequent transactions consummated during the thirteen (13) months following the valid termination of the engagement agreement. Although Oneida provided written notice of its termination of the engagement agreement in April 2005, Oneida took the position that because the agreement provided that "either [Oneida] or [the investment banker] ***may*** terminate this agreement upon 30 days notice delivered in writing," that the engagement agreement "does not require written termination and that its obligations to [the investment banker] terminated in August 2004 when it completed the work it was hired to perform, was sent a bill and was paid in full."[69] Although the court ruled in Oneida's favor and dismissed the investment banker's claim to a second success fee concerning an unrelated subsequent transaction,[70] more concise drafting in the termination provision of the engagement agreement and overt actions on the part of Oneida (*i.e.*, providing written notice of termination at the conclusion of the initial transaction) would have avoided the time-consuming and expensive dispute.

As the foregoing discussion illustrates, in order for the investment bank and its corporate client to receive the benefit of the bargain they negotiated in an engagment letter, it is crucial that they clearly and unambiguously set forth their respective duties, rights and obligations in the agreement. This is especially true in some of the more highly-contested areas

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[67] *Id.* at ¶ 133-136.

[68] *In Re Oneida Ltd.,* 400 B.R. 384 (S.D.N.Y. 2009).

[69] *Id*. at 388 – 91 (emphasis added). Oneida subsequently filed a pre-packaged bankruptcy plan in the spring of 2006 that, if the fee tail remained in effect, would have entitled the investment banker to a second fee that was larger than the original fee. The investment banker interpreted the agreement as requiring Oneida to provide written notice of termination to end the engagement and that, absent such written termination notice, the fee tail would remain in effect to entitle the investment banker to a second fee.

[70] *Id*. at 392 (relying partially on § 235(1) of the Restatement (Second) of Contracts which provides that "full performance of a duty under a contract discharges the duty," the court ruled that the investment banker's "construction of the contract must be rejected on grounds that it leads to an absurd result").

where ambiguous drafting may adversely affect a party, including (a) the definition of the "Transaction" that is the subject of the engagement, (b) the concept of an exclusive versus non-exclusive engagement and (c) the terms of the agreement's fee structure.

V. THIRD PARTY BENEFICIARIES ISSUES

Another critical issue that may lead to unintended consequences for the investment bank is whether, and to what extent, persons who are not parties to the contract (*e.g.*, affiliates of a signatory) are intended to have the benefit of the engagement letter—the third party beneficiary quandary. As illustrated by the case law noted below, careful drafting is required to ensure the engagement letter accurately addresses the parties' desired objectives regarding which persons other than the signatories will have legal rights to enforce the terms of the agreement or share in its benefits. The failure to specifically address the inclusion of intended (or exclusion of unintended) third party beneficiaries may potentially lead to unintentional and adverse results for the parties and relegate the determination of the issue to somewhat murky jurisprudential waters.

A. General Overview of Key Issues

Typically, courts follow the "third party beneficiary test," as set out in § 302 of the Restatement (Second) of Contracts, which allows only intended beneficiaries, and not "incidental beneficiaries," to have standing to sue for a breach of contract or otherwise enforce its terms.[71] The Restatement's third party beneficiary test provides that a beneficiary is an intended beneficiary "if recognition of the right to performance in the beneficiary is appropriate to effectuate the intention of the parties, and either the promisor's performance will satisfy an obligation of the promisee to pay money to the beneficiary, or the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance."[72] Although courts have been somewhat reluctant to afford certain parties (*e.g.*, corporate shareholders) directly enforceable rights as third party beneficiaries to corporate contracts in which they are not signatories,[73] including, but not limited to, investment bank engagement letters, it is important for investment banks and their clients to be mindful that an intended beneficiary need not be expressly mentioned in the engagement letter before third-party beneficiary status can be established.[74] Rather, only the parties' intent that a specific third party benefit from (or be

[71] *See generally MCI Telecomms. Corp. v. Tex. Utils. Elec. Co.*, 995 S.W.2d 647, 651 (Tex. 1999); *Louis Frey Co., Inc. v. Am. Reprographics Co., LLC (In re Louis Frey Co., Inc.)*, No. 03-15297 (SMB), 2006 Bankr. LEXIS 1523, at *94-95 (Bankr. S.D.N.Y. July 28, 2006); *Trans-Orient Marine Corp. v. Star Trading & Marine, Inc.*, 925 F.2d 566, 573 (2d Cir. 1991); *Comrie v. Enterasys Networks, Inc.*, C.A. No. 19254, 2004 WL 5366650, at *7 (Del. Ch. April 27, 2004), *aff'd*, 864 A.2d 929 (Del. 2004).

[72] *In re Louis Frey Co., Inc.*, 2006 Bankr. LEXIS 1523, at *94-95.

[73] *Orban v. Field*, No. Civ. A. 12820, 1993 Del. Ch. LEXIS 277 (Del. Ch. Dec. 30, 1993).

[74] *Fireman's Fund Ins. Co. v. Glass*, No. 94 Civ. 7375 (WK), 1997 U.S. Dist. LEXIS 7518 (S.D.N.Y. May 30, 1997).

subject to) the agreement needs to be shown on the face of the contract in order to convey such rights on the unnamed third party.[75]

Two recent decisions illustrate how careful drafting, or the lack thereof, with respect to investment bank engagement letters can determine the outcome of whether third party beneficiary status is granted by the courts to unnamed third parties. Interpreting New York law, the court in *Baker v. Goldman Sachs & Co.*[76] determined that inconsistent drafting in an agreement in which Goldman Sachs was engaged to provide financial advisory services evidenced an intent by the parties to include one of the engaging company's controlling shareholders as a third party beneficiary. The engagement letter in *Baker* was addressed to, and signed by, Janet Baker, the company's Chief Financial Officer (who also happened to be a director and, together with her spouse, a controlling shareholder of the company). After the investment closed, the company uncovered accounting fraud in the target resulting in the loss of its investment in the target. Janet Baker subsequently brought suit as a controlling shareholder and director against Goldman Sachs for breach of contract and fiduciary duties. Goldman Sachs sought to have the case dismissed claiming that the plaintiff was not a party (or intended beneficiary to the agreement). Although the agreement contained a statement that Goldman Sachs would not be liable for shareholder derivative suits and that Goldman Sachs was being engaged directly by the company, the court focused on the fact that Goldman Sachs addressed Janet Baker in her individual (as opposed to representative) capacity and the ambiguous text of the engagement letter that stated Goldman would "provide *you* with financial advice and assistance . . . [in] searching for a purchaser acceptable to *you* . . . and assisting *you* in negotiating the financial aspects of the transaction."[77]

Applying New York law, the court in *Baker* reasoned that Goldman Sachs' choice of language in using the personal pronoun "you" reflected its understanding that other persons besides the company were intended to benefit from its advice and services and that Janet Baker, in her individual capacity, was one such intended third-party beneficiary.[78] The court was further influenced by Janet Baker's active participation in the transaction and found the relationship between the parties to be "muddy" because, among other things, Goldman Sachs did not expressly waive any extra-contractual fiduciary duties in the engagement letter.

In contrast to the *Baker* decision, the Seventh Circuit in *Joyce v. Morgan Stanley*[79] held that the plaintiff shareholders of a company did not have a claim for breach of fiduciary duty against Morgan Stanley, the company's investment bank engaged in connection with a stock-for-stock merger. In this case, the shareholders sought compensation from Morgan Stanley for losses sustained a result of the merger target's share-price plunge after Morgan

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[75] *Id.* at 8.

[76] *Baker v. Goldman Sachs & Co.*, 656 F. Supp. 2d 226 (D. Mass. 2009).

[77] *Id.* at 235 (emphasis added).

[78] *Id.*

[79] *Joyce v. Morgan Stanley & Co., Inc.*, 538 F.3d 797 (7th Cir. 2008).

Stanley issued a fairness opinion on the merger. The company's shareholders maintained that Morgan Stanley owed them an extra-contractual fiduciary duty to advise them about hedging transactions to minimize their exposure to a potential loss in value of the merger target's stock. The court rejected the shareholders' claim on the basis that no fiduciary duty toward the shareholders ever arose and that, because of the textual references and disclaimers contained in the engagement letter and the fairness opinion, Morgan Stanley had no duty to advise the shareholders about potential risks associated with the investment.

In support of this conclusion, the court noted that the text of the engagement letter made no reference at all to the company's shareholders and stated that "Morgan Stanley will act under this letter agreement as an independent contractor with duties solely to [the company]."[80] Further supporting its position that the shareholders had no third-party beneficiary rights and were owed no fiduciary duties by Morgan Stanley, the court relied on a similar disclaimer in Morgan Stanley's fairness opinion, which provided the following language:

> It is understood that this letter is for the information of the Board of Directors of the Company, except that this opinion may be included in its entirety in any filing required to be made by the Company in respect of the Merger. Morgan Stanley expresses no opinion as to the relative valuations of each of the voting and non-voting [company] Common Stock and [company] Preferred Stock . . . and Morgan Stanley ex-presses no opinion or recommendation as to how the holders of [company] Common Stock should vote at the shareholders' meetings held in connection with the Merger.

Because of the language included by Morgan Stanley in the engagement letter and fairness opinion, the court concluded that Morgan Stanley never owed any contractual nor extra-contractual duties to the plaintiff shareholders.

B. Drafting Considerations

Considered together, *Baker* and *Joyce* underscore the importance of cautiously drafting third party beneficiary provisions in engagement letters. Investment banks, their clients and their respective counsel should be aware of, and consider the following:

- Consistently and clearly identify the client and the nature of the relationship between the client and the investment bank. As evidenced by the *Baker* decision, it is imperative that the client and other intended beneficiaries (if any) be included as addressees, signatories and throughout the text of the engagement letter. The nature of the relationship between the investment bank and the client (*e.g.*, independent contractor) also needs to be clearly established and properly described. The same description of the client should be carried through to any opinion provided by the investment bank or in any other ancillary agreement entered into in connection with the engagement letter.

[80] *Id*. at 802.

- Include disclaimers and non-reliance provisions as appropriate. If appropriate, the investment bank should clearly disclaim any duties, obligations or other liabilities (whether direct or indirect, in contract, tort or otherwise) to third parties not party to the agreement, including the client's stockholders. Similarly, as seen in the *Joyce* decision, fairness opinions provided by investment banks in the course of their engagement should also provide appropriate disclaimers and clarifying language expressly addressing (a) the intended beneficiaries of the fairness opinion and those persons that are not the intended beneficiaries of, or entitled to rely on, the fairness opinion, (b) the purpose and permitted uses of the opinion, and (c) any other limitations, including clearly disclaiming those items clearly outside the scope of the investment bank's opinion.

- Clearly describe any potential conflicts of interest. It is important to call attention to all significant potential conflicts the investment bank may face in its representation of the client and obtain a written waiver of any such potential conflict. Because the engagement letter is typically the first (and sometimes the only) written agreement executed by the investment bank and its client, it is an appropriate and ideal place to address such conflicts.

VI. KEY BANKRUPTCY CONSIDERATIONS

There are special considerations when entering into engagement letters in the context of a bankruptcy filing. The Bankruptcy Code provides two key standards by which the court may review and approve (or not) a retained financial advisory professional's engagement and payment. First, professionals retained under § 330(a) of the Bankruptcy Code must periodically submit applications for compensation, typically on an hourly basis, which the court will then review under a reasonableness standard. Second, professionals retained under § 328 of the Bankruptcy Code may have their compensation (such as on a fixed fee, percentage fee, contingent fee and/or monthly fee basis) pre-approved at the time of their retention. When a professional is employed under § 328, as opposed to § 330, a bankruptcy court will usually not revisit the terms of compensation that it previously pre-approved unless "such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions."[81]

A. Section 328

Section 328 of the Bankruptcy Code establishes the framework for professionals, including investment bankers and other financial advisory professionals, to obtain pre-approval of their compensation arrangements from the court. Subsection 328(a) permits the trustee, or a committee appointed under section 1102 of the Bankruptcy Code, to employ or authorize the employment of a professional person pursuant to Section 327 or 1103 with the court's approval, and fixes the maximum compensation allowable to a professional person employed under section 327. Section 328 authorizes the trustee to employ professionals on reasonable terms, including (without limitation) on a retainer, on an hourly basis or on a contingent fee basis. Section 328(a)

[81] 11 U.S.C. § 328(a).

further permits the court to modify a previously approved agreement if such agreement (or any specific provision contained therein) is later deemed improvident in light of a development that was incapable of being anticipated at the time the agreement was originally approved.

1. General Approval Considerations

Bankruptcy courts cautiously fulfill their obligation to determine the reasonableness of terms and conditions before approving employment under § 328(a) and may eliminate, modify, or impose additional terms and conditions to ensure reasonableness.[82] Financial advisors and other professionals seeking approval of their compensation arrangements under § 328 should be mindful of the non-exclusive list of factors that bankruptcy courts consider when determining whether to approve an employment arrangement.[83] Aside from these factors, financial advisors should also be concerned with additional criteria that have been adopted by bankruptcy courts specifically relating to an investment banker's retention application under § 328(a).[84]

The retention application must also include a copy of the actual retention agreement between the investment banker/adviser and the client, and the party retaining the advisor must describe the process by which the advisor was selected to offset the perceived lack

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[82] *In re High Voltage Eng'g Corp.*, 311 B.R. 320, 333 (Bankr. D. Mass. 2004).

[83] *Id.* (quoting *In re Insilco Techs., Inc.*, 291 B.R. 628, 633 (Bankr. D. Del. 2003)). These factors include:

- whether terms of an engagement agreement reflect normal business terms in the marketplace;
- the relationship between the debtor and the professionals, i.e., whether the parties involved are sophisticated business entities with equal bargaining power who engaged in an arms-length negotiation;
- whether the retention, as proposed, is in the best interests of the estate;
- whether there is creditor opposition to the retention and retainer provisions; and
- whether, given the size, circumstances and posture of the case, the amount of the retainer is itself reasonable, including whether the retainer provides the appropriate level of "risk minimization," especially in light of the existence of any other "risk-minimizing" devices, such as an administrative order and/or a carve-out.

[84] *In re Energy Partners, Ltd.*, 409 B.R. 211, 233 (Bankr. S.D. Tex. 2009). To obtain approval, an investment banker's retention application needs to contain:

- the scope and complexity of the assignment;
- its anticipated duration;
- expected results;
- required resources;
- the extent to which highly specialized skills may be needed and the extent to which they have them or may have to obtain them;
- projected salaries of participating professionals;
- billing rates and prevailing fees for comparable engagements;
- current retentions in bankruptcy by the retained firm; and
- any estimated lost opportunity costs due to time exigencies of the job.

of competitiveness in the selection process.[85] Furthermore, the application must explain how the investment banker/advisor will minimize the duplication of efforts by other employed professionals.[86]

B. Bankruptcy Drafting Considerations

1. Evaluation of Transaction Fees

A transaction fee is a fee earned by an investment banker upon the successful completion of the transaction contemplated by the engagement letter. It is important for financial advisors to note the timing issues with respect to a bankruptcy court's evaluation of transaction fees. It is not uncommon for bankruptcy courts, when approving arrangements pursuant to § 328, to deny a financial advisor's entitlement to a transaction fee if a plan of reorganization other than the original plan is consummated. For example, in *In re XO Communications, Inc.*,[87] the bankruptcy court approved a transaction fee of up to $20 million upon consummation of the subject transaction pursuant to section § 328. Houlihan Lokey Howard & Zukin Capital agreed to serve as XO Communications' restructuring financial advisor and, under the terms of its engagement letter, XO Communications was obligated to pay Houlihan Lokey a monthly fee of $250,000 and a transaction fee, payable upon the closing of a "Transaction." [88] The transaction fee was connected to the amount of the various debt and preferred stock obligations that were "restructured, modified, amended, forgiven or otherwise compromised" as part of the Transaction.[89] Although the agreed upon transaction fee was approved by the court, the final order entered by the bankruptcy court approving the reorganization plan expressly curtailed the financial advisor's entitlement to the transaction fee if a different plan was consummated.[90] The take away from this case is that in the bankruptcy context, the instances upon which a success fee is earned should be described in more general terms because if the agreement is negotiated with a specific reorganization in mind and the structure of the plan that is ultimately approved materially changes, then the ability of the advisor to earn its fee may be jeopardized.

Aside from the transaction fee issues resulting from the consummation of an alternate plan, it is also helpful to know that external forces such as market conditions can influence a bankruptcy court's decision to disallow a transaction fee. As previously noted, § 328(a) provides bankruptcy courts with discretion to disallow transaction fees if the terms turn out to be improvident in light of developments not capable of being anticipated at the time of

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[85] *Id.* One important drafting consideration here is that the parties should make sure that any confidentiality provision(s) included in the engagement letter contains an exception that permits this disclosure.

[86] *Id.*

[87] *In re XO Commc'ns, Inc.*, 323 B.R. 330 (Bankr. S.D.N.Y. 2005), *aff'd*, 369 B.R. 111 (S.D.N.Y. 2007).

[88] *Id.* at 334.

[89] *Id.* at 335.

[90] *Id.* at 337.

their fixing.[91] In one case, the Bankruptcy Court for the District of Delaware took into account the fact that the U.S. economy began suffering distress shortly after the debtors hired their financial advisor.[92] Because the economic crisis was unforeseeable and clearly diminished the value of the two divisions the debtor was selling, the court found that payment of the pre-approved transaction fee "would be highly inequitable and improper."[93]

2. Right to Request a Fee vs. Right to Receive It

When negotiating and drafting an engagement letter, financial advisors should be aware of avoidable drafting choices that bankruptcy courts may interpret to reduce fee awards. For example, in *In re Northwest Airlines Corp.*,[94] Lazard's retention application listed monthly compensation of $275,000 and a "right to request a success or completion fee" without specifying the amount of the fee to be requested.[95] Although the compensation arrangement was pre-approved under § 328, the court denied Lazard's requested $3,250,000 completion fee, stating that the financial advisor got just what it bargained for—the right to make a request.[96] The court noted that as a sophisticated party that touted its financial advisory experience in other chapter 11 actions, Lazard should have known "that the 'right to deny' a request is the companion to the 'right to make' the same request."[97] The court explicitly stated that Lazard was "obviously confusing a 'right to request' a fee with 'a right to receive' a fee."[98] After finding that Lazard's application for a success or completion fee did not meet the standards outlined under § 330 of the Bankruptcy Code, the court denied Lazard's request for a success or completion fee.[99] Thus, financial advisors should protect themselves by expressly incorporating a provision in their engagement letters that preserves their "right to receive a fee" as opposed to the "right to request a fee." Additionally, investment banks may consider incorporating in their engagement letters a range for the success fees to be earned or certain benchmarks depending on the likelihood of success in order to ensure a greater likelihood of receiving their negotiated fees.

3. Specify The Amount of The Applicable Fees

Along the same lines, if seeking approval under § 328, it is best for financial advisors to set the exact "terms" of their compensation and retention in their retention

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[91] *See e.g.*, *In re Pro-Snax Distribs., Inc*., 157 F.3d 414 (5th Cir. 1998).

[92] *In re Distributed Energy Sys. Corp.*, No. 08-11101 (KG) (Bankr. Del. May 18, 2009).

[93] *Id.* at 8.

[94] *In re Nw. Airlines Corp.*, 382 B.R. 632 (Bankr. S.D.N.Y. 2008).

[95] *Id.* at 636.

[96] *Id.* at 652.

[97] *Id.*

[98] *Id.* at 641.

[99] *Id*. at 652.

applications thereby informing the bankruptcy court as to the proposed fee amount or the terms under which fees will be earned. If the amount of the fee is not included, bankruptcy courts may take the position that the fee "could not have been contemplated—much less pre-approved."[100] Even if such terms exist elsewhere, the failure to disclose them would violate Federal Rule of Bankruptcy Procedure 2014. A court can only approve compensation arrangements identified and defined in applications filed pursuant to applicable Bankruptcy Code and Rules. For example, Local Rule 2014-1 for the Southern District of New York requires an application for the employment of a professional person pursuant to § 327 and § 328 to declare, among other things, the "terms of any retainer and the hourly or contingent fee arrangement."[101]

4. Definition of Terms

Financial advisors should likewise include definitions of key components of their compensation arrangements in their engagement letters and retention applications.[102] One case that illustrates the pitfalls of failing to do so is *Northwest Airlines*, in which a court found that Lazard's retention application and engagement letter did not meet these requirements, because it was silent as to the definition of the terms "success fee" and "completion fee."[103]

5. Completion Fees v. Success Fees

Although the *Northwest Airlines* court did not distinguish between a success fee and a completion fee and deemed the terms to be interchangeable, the court expressed disfavor towards completion fees.[104] The court reasoned that while it seems logical that a party may be awarded a success fee after proving that it achieved a level above what was expected of it upon retention, the use of the term "completion fee" in place of "success fee" could be an attempt to avoid demonstrating or qualifying the "success" of the professional.[105] In the court's words, "[a] fee of this kind would seem to reward professionals for nothing more than remaining employed by and loyal to a Committee, Debtor or Estate."[106] The *Northwest Airlines* court found that the concept of a "completion fee," without further explanation or definition, would be contrary to the purposes of reorganization under the Bankruptcy Code.[107]

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[100] *Id*.

[101] *Id*. at 641.

[102] *Id*.

[103] *Id*.

[104] *Id*. at n.3.

[105] *Id*.

[106] *Id*.

[107] *Id*.

6. Bonuses for Extraordinary Results

Financial advisors engaged in bankruptcy cases should also be cognizant of the fact that after § 328 approval, fee enhancements or bonuses are difficult to obtain without a corresponding provision in the engagement letter. For example, in *In re Nucentrix Broadband Networks, Inc.*,[108] the Bankruptcy Court for the Northern District of Texas rejected Houlihan Lokey's application for a bonus as a reward for the extraordinary result obtained as the debtor's financial advisor. The court previously approved Houlihan Lokey's fees of $800,000 at the time of its engagement pursuant to § 328. The court reasoned that even though the sale process developed by Houlihan Lokey and the debtor's counsel achieved unexpectedly successful results, the success of the auction was capable of being anticipated. Essentially, although the magnitude of success in the auction process likely was unforeseen when Houlihan Lokey sought § 328 protection, the possibility of an increased bid was certainly capable of being anticipated, and the requirements to alter Houlihan Lokey's § 328-approved fee were not met. Thus, when negotiating an engagement letter, financial advisors should negotiate and include a specific clause in their engagement letters providing for the receipt of a bonus for the achievement of an extraordinary result if such a term is intended by the parties. As seen in *In re Nucentrix Broadband Networks*, if an investment banker pushes for pre-approval of its engagement letter under § 328, the investment banker will likely only be entitled to what it negotiated in the agreement as courts rarely interpret or revisit engagement letters to increase fees in favor of the investment banker.

7. Tail Period Concerns

A tail period refers to a company's obligation to pay a success fee to its financial advisor upon a triggering event that occurs during a period of time after the engagement has been terminated. In chapter 11 cases, bankruptcy courts have been hesitant to approve applications to employ investment bankers that insist on tail fees without scrutiny. For example, the Bankruptcy Court for the Southern District of Texas, Houston Division, has stated that "there is a presumption of unreasonableness in any proposed retention by a professional who requires a tail period in addition to the other requested categories of compensation."[109] However, while the court will not approve such terms of retention merely because the terms are routine in the investment banking community, the court may still award the tail fee as long as sufficient justification is given. For instance, in *In re Bigler*, the court took into consideration the debtor's extensive negotiations, the financial advisor's overall fee structure, and the unique experience that the advisor brought to the case and on this basis, ultimately found that the presumption of unreasonableness created by the tail period had been overcome.[110]

As discussed in the foregoing sections, there are a number of unique considerations that clients and investment bankers must take into account when entering into

[108] *In re Nucentrix Broadband Networks, Inc.*, 314 B.R. 574 (Bankr. N.D. Tex. 2004).

[109] *In re Bigler, LP*, Jointly Administered Under Case No. 09-38188 (Bankr. S.D. Tex. 2010) (Bankr. S.D. Tex. 2010).

[110] *Id.*

engagement letters in the bankruptcy context. In addition to the issues related to the retention of advisors by debtors and a bankruptcy court's approval of advisor fees, investment banks and their debtor clients must be cognizant of other bankruptcy-related engagement letter issues like detailed record-keeping requirements and advisor indemnification concerns—both of which are hot button issues for United States trustees. Counsel to corporate clients and investment bankers are well-advised to consult bankruptcy specialists prior to executing engagement letters in which bankruptcy or reorganization of the corporate client is a possibility in order to address in advance any bankruptcy-related concerns that may impact the advisor's engagement.

VII. CONCLUSION

As the topics addressed in this Article clearly illustrate, the process associated with negotiating and drafting an investment bank engagement letter is replete with traps for the unwary banker and its client. Absent keen attention to the issues discussed herein, investment banking engagement letters can create significant liabilities and be the source of significant disputes. It is critical, therefore, that bankers and their clients clearly delineate the expectations of both parties in a carefully negotiated and specifically tailored letter, rather than rushing through this critical initial step or trying to keep the lawyers out of it on the basis that it's a straight forward standard form. Both sides would benefit from the added attention and thoughtfulness concerning the issues discussed in this paper as well as others.