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Bankers Beware: The Judicial Divide Over Customary Investment Banking Fees

By Curtis Leitner, Peter Gennuso and MarcAnthony Bonanno

New York is the heart of the capital markets. Companies rely on placement agents, brokers, and investment bankers to help them raise capital for a success fee, which is often a percentage of the capital raised. But negotiating a clear-cut fee can be challenging. Capital can be raised in many different forms (debt or equity, short term or long term, active or passive) and the ultimate form of the deal may be unforeseeable. Fee provisions can remain in effect for several years, the so-called "tail" period, during which market conditions can dramatically change. As a result, investment banking agreements sometimes provide for a customary or market-based fee—for example, a fee "consistent with investment industry practice."

CURTIS B. LEITNER *is a business litigation partner,* PETER J. GENNUSO *is a corporate partner and* MARCANTHONY BONANNO *is an associate at McCarter & English. They can be reached at cleitner@mccarter.com, pgennuso@mccarter.com and mbonanno@mccarter.com, respectively.*

Over the past few decades, a deep split has developed between New York's state and federal courts over the enforceability of fee provisions incorporating general commercial practice. The First Department has upheld them, but federal judges in the Southern District have invalidated them as unenforceable "agreements to agree." Below, we explain this divide among the New York courts. We also suggest that the divide is driven by a difference in the courts' willingness to allow contracting parties to punt on a material term.

The First Department's Position

In the leading state court decision, *Cowen v. Fiserv*, 141 A.D. 3d 18 (1st Dep't 2016), the First Department held that contracting parties have substantial leeway to write customary fees into an investment banking contract. An investment bank provided advisory services to a company contemplating an acquisition. The parties agreed that the


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investment bank was entitled to a "Transaction Fee" if an acquisition occurred.

The fee provision did not specify a dollar amount or percentage of the purchase price. Rather, the parties agreed to "work in good faith to determine the amount of the Transaction Fee" that "shall be consistent with *investment banking industry practice* for transactions of comparable complexity, level of analysis, and size" (emphasis added). After the acquisition closed for $465 million, the company refused to pay the Transaction Fee, arguing that the fee provision was an unenforceable "agreement to agree."

The principals of the bank and the company had discussed the Transaction Fee before the deal closed, and as part of those discussions, the bank sent the company surveys of M&A advisor fees sourced by a research firm. The surveys, called "fee runs," reflected publicly reported investment banking fees. The fee runs showed that deals ranging from $300 million to $500 million had a mean fee of approximately 1% of the purchase price. The bank's experts testified that the use of fee runs is standard practice in the industry and that investment banking fees are often determined after signing a contract because the "structure, size, and complexity of a transaction are often not clear at the time the letter is signed."

The First Department held that the fee provision "explicitly references the type of 'commercial practice or trade usage' New York courts routinely rely upon to render a price term sufficiently definite," and therefore an enforceable fee "may be ascertained from public price indices and industry practice." The First Department also noted that the parties' discussion of fee runs without objection—*before* the dispute began—was "consistent with an intent to be bound."

The Southern District's Position

A series of Southern District decisions take the opposite position: An investment banking fee provision that merely references commercial practice is an unenforceable "agreement to agree." The most recent decision, *Stone Key Partners v. Monster Worldwide*, 333 F. Supp. 3d 316 (S.D.N.Y. 2018), considered a compensation clause stating that the fee would be "mutually acceptable to the [client company] and [the investment bank] and consistent with compensation agreements *customarily agreed to by nationally recognized investment banking firms* for transactions of similar size and complexity where there are two co-financial advisors" (emphasis added).

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The court's analysis turned on a premise that was nowhere to be found in *Cowen*—or in the New York cases that "routinely" (in *Cowen*'s words) uphold fee provisions that reference commercial practice. Specifically, *Stone Key* quoted an earlier Southern District case for the proposition that "[w]hen compensation is calculated with reference to industry standards or customs, the plaintiff must establish that the omitted term is *fixed and invariable in the industry in question*" (emphasis added).

The court held that the investment banking firm's evidence of industry standards failed to meet that exacting standard. At trial, both sides' experts agreed that the fee provision called for a fee run in the first instance—i.e., a collection of publicly available fees for precedent transactions. After that point, however, the banking firm's expert made a number of "subjective choices" in analyzing the fee runs—"for example, to consider fees for transactions between $50,000,000 and $100,000,000, to consider just some rather than all quartiles [of fees], to take the mean to maximum fees and exclude the minimum, and to add a particular premium." Further, although the fee provision required consideration of the "complexity" of the deal and analogous fees for "co-financial advisors," the fee runs did not show complexity or the involvement of co-advisors. The court concluded that fee runs are a starting point for further judgments and negotiation regarding a fee—not a "fixed and invariable" custom.

The *Stone Key* court held that *Cowen* was inapposite for two reasons. First, the court distinguished *Cowen* because, in that case, the parties' prelitigation course of conduct (discussing fee runs without objection) showed an agreement on a fee methodology. No similar course of conduct took place in *Stone Key*.

Cowen is not so easily distinguished, however. After stating that New York courts "routinely" uphold fee provisions incorporating "commercial practice," *Cowen* ruled that "the record demonstrates that sophisticated parties intended to be bound by an agreement," and therefore "the doctrine of definiteness should not be used to defeat the bargain of the parties." It was only *after* the First Department had made this ruling that it referenced the parties' pre-litigation conduct.

Second, *Stone Key* explicitly rejected *Cowen*'s reasoning. The Southern District explained that *Cowen* was "not binding," and was unpersuasive because it "gave no consideration to either the subjective choices that underlie a fee run or the negotiations required for parties to fix upon a fee even after completing the fee run." For its part, *Cowen* noted the earlier Southern District decisions relied on by *Stone Key* "are of course not binding" on the First Department and had never been relied on by a state court.

The Fixed and Invariable Standard

The disagreement between the First Department and the Southern District turns on whether the "fixed and invariable" standard for evidence of custom applies to a fee provision that expressly incorporates custom—i.e., investment banking practice. The Southern District says yes, and the First Department, at least implicitly, says no. But neither side fully explains its position.

Black letter contract law on custom and usage evidence does not help. If a contracting party offers evidence of industry custom to inform the meaning of an ambiguous contract term or to fill in a missing term, New York courts generally require proof of a fixed and invariable custom. The reason is that industry custom is not reliable evidence of the parties' intent—the lodestar of contract interpretation—unless the custom is fixed and invariable. In other words, to "raise a fair presumption that [a custom] was known to both contracting parties and that they contracted in reference thereto," the custom must be fixed and invariable. *Reuters Ltd. v. Dow Jones Telerate*, 231 A.D.2d 337, 343-44 (1st Dep't 1997).

In cases like *Cowen* and *Stone Key*, however, there is no question that the parties "contracted in reference" to investment banking practice. Their own words—a fee based on "investment banking industry practice" (*Cowen*) and a fee "customarily agreed to by nationally recognized investment banking firms" (*Stone Key*)—demonstrate that they agreed to a fee determined by investment banking practice. The real issue dividing the courts is whether investment banks and their clients can agree to a flexible and subjective price term that could require further negotiation and, if negotiation fails, a battle of investment banking experts in court. In other words, do investment banks and their clients have the flexibility to punt on compensation until the capital raise is complete and all the facts are known?

Conclusion

Neither the First Department nor the Southern District has the last word on New York law, and the New York Court of Appeals has not weighed in on the enforceability of customary investment banking fees. Until it does, bankers beware. They can have certain enforceability or a flexible, customary fee—but not both.