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PAYING TO BREAK UP: THE RISE OF REVERSE TERMINATION FEE PROVISIONS

I. Introduction

A. The goal of this paper is to evaluate the origins, uses and potential endurance of reverse termination fee provisions in acquisition agreements.

1. Reverse termination fee provisions arose in the 1980's in the context of two competing companies entering into a merger transaction. Since a combination of two competitors could involve regulatory risk that may hinder completion of the deal, the parties to the acquisition agreement provided for a fee to be paid from the buyer to the seller in the event that regulatory approval could not be obtained.

2. Post-2005, reverse termination fees became a commonplace provision in acquisition agreements involving public company sellers and private equity buyers.

3. The deterioration of the credit markets in the second half of 2007 prompted a number of private equity buyers to abandon their deals claiming that the reverse termination fee provision in these acquisition agreements gives the buyer a pure walk away right if it pays the fee. Accordingly, during the past two years the provision has been at the center of heated debate between buyers and sellers in merger transaction litigation in the Delaware courts.

4. After selling companies realized that the reverse termination fee could be used as an option to refuse to close a transaction, many practitioners and commentators believed that the reverse termination fee provision would largely disappear, and that boards of selling companies would likely negotiate for greater certainty in acquisition agreements.

5. This prediction has thus far failed to transpire; in fact, reverse termination fee provisions have continued to play a role in private equity acquisitions of public companies and are now cropping up in numerous acquisition agreements including deals between strategic (i.e., non-financial) sellers and buyers without being tied to any specific antitrust risk and with a bar on

specific performance of the contract by the buyer.

6. The purpose of this work-in-progress is to determine how and why the reverse termination fee provision became an oft-used provision in acquisition agreements.

7. I believe that the story of the rise of the reverse termination fee provision is important for two reasons:

    a. First, it illustrates the agency problem between boards and shareholders.

    b. Second, it suggests that the exceptionally deferential approach that the Delaware courts and legislature have taken to decision-making by boards, even in change of control transactions, may be problematic.

II. Traditional Uses of the Reverse Termination Fee Provision

A. Reverse termination fees have been used in acquisition agreements since the 1980s, primarily in deals involving strategic buyers where the transaction had antitrust or other regulatory risk.

B. Two cases from the mid-1990s where the parties litigated the reverse termination fee payment due to failure to obtain regulatory clearance illustrate the general pre-2005 use of reverse termination fee provisions. In both cases, the court awarded the reverse termination fee to aggrieved sellers in circumstances where the parties failed to gain regulatory approval for the acquisition. *See generally LTV v. Thomson-CSF (In re Chateauguay Corp.), 186 B.R. 561 (Bankr. S.D.N.Y 1995); In re El Paso Elec. Co., Case No. 92-10148-FM (Bankr. W.D. Tex. Apr. 10, 1997) (unpublished interim order).*

III. Private Equity and the Going-Private Boom of 2005-2007

A. Historical Structure of Private Equity Transaction

1. Private equity buyouts commonly involve leverage and a shell buyer:

    a. These "shell buyers" are generally the only buyer party to the acquisition agreement so as to limit the selling company's recourse to the private equity firms for breaches of the agreement.

2. The shell buyer draws on financing from two separate sources:

    a. Equity financing commitments from the private equity firms, and

    b. Debt financing commitments from a consortium of lenders.

B. Traditional Terms for Allocating Financing-Related Closing Risks in Private Equity Acquisition Agreements

1. Some agreements included a "financing out" with a specific performance

provision to ensure that the buyer tried to get financing. If the buyer was unable to procure financing, the financing out condition enabled the buyer to walk away from the deal.

2. Specific Performance

   a. It is unclear whether this specific performance remedy had any real value since most deals were between the shell buyer and the seller.

3. Other assurances in addition to specific performance include:

   a. Executed equity and debt commitment letters from the sponsor and its financiers delivered at the time of signing the merger agreement for the full amount of the funds necessary to close the transaction, with the conditions to funding under the debt commitments dovetailing as closely as possible with the analogous conditions to closing under the merger agreement; and

   b. A commitment on the part of the sponsor affiliate that is a party to the merger agreement to use its reasonable best efforts to draw down on its funding sources at closing (or to find a replacement source for the debt financing if necessary).

C. The Shift in Allocation of Financing Risk: The Rise of Reverse Termination Fees & the Abandonment of Specific Performance

1. The 2005-07 period was the height of M&A activity involving private equity buyers.

2. Beginning in 2005 the allocation of financing risk began to change dramatically through the introduction of reverse termination fees. In describing this change I will:

   a. First, describe the reverse termination fee provisions that became commonplace in acquisition agreements,

   b. Second, explain the motivations for each side in an M&A transaction for agreeing to reverse termination fees,

   c. Third, describe the typical method for determining the amount of the reverse termination fee.

3. Reverse termination fees in more detail

   a. There are different flavors of reverse termination fees, but generally they allowed a buyer to walk away from closing the deal subject to payment of a fee.

      i. Pure reverse termination fee: The buyer has a right to walk from the deal for any reason by paying a reverse termination fee. The reverse

termination fee is the seller's exclusive remedy if the sponsor does not close the transaction for any reason, and therefore the contract does not provide for a specific performance right.

ii. Reverse Termination Fee with Specific Performance: Under this approach, if debt financing is available to the buyer (or the buyer breaches the merger agreement such as would cause the debt financing to not be available), then the seller is entitled to seek specific performance and ask a court to order the buyer to use its required efforts to draw down on the debt and equity financing and close the transaction.

(1) As in the traditional version of the LBO acquisition agreement, here too it is unclear whether the specific performance is of any real value since the buyer party to the acquisition agreement remained the shell entity.

4. Motivations for switching to the reverse termination fee model

a. Originally, motivations for switching to the reverse termination fee model were described as being more seller friendly, because it provided a potentially higher remedy for a seller than contracts that included a financing out.

i. The problem was that while a financing out allowed the buyer to walk away only when it could not secure financing, the reverse termination fee allowed the buyer to walk away for any reason.

b. The private equity firms argued that the reverse termination fee should make their offers more attractive to sellers because these provisions were seen as less risky for seller companies than the historical financing out provisions in private equity acquisition agreements. In fact, the private equity firms went so far as to argue that because of reputational factors, they presented to seller companies a less risky proposition than strategic buyers.

i. This argument is best summarized by the court in the *In re Topps* decision: "Apparently, financial buyers argue with a straight face that they should, because of reputational factors, be considered as presenting a lower risk of consummation for lack of financing than strategic buyers. Thus, in the past, financial buyers always argued for a financing out. Now, they say that they will agree to no out but only if their liability is capped at the amount of a reverse break-up fee. Meanwhile, strategic buyers continue to be asked to accept full liability for damages caused if they fail to close, even if the reason for not closing is based on financing, not a risk unique to a strategic buyer. This is an interesting asymmetry, and the factors driving it seem to include both economically rational ones and ones that are less rational." *In re Topps*, 926 A.2d 58, 72 n.11 (Del. Ch. 2007).

5. Failure of board process and problematic disclosure?

    a. Target company boards agreed to this provision with an expectation that buyers would likely not walk away from the transaction because of reputational forces, and that they would at least receive a hefty fee in the event a buyer walked away from the acquisition. Boards often claimed to their shareholders that these deals were not subject to financing.

    b. One of the most troubling developments in the rise of the reverse termination fee provision was the process by which the actual amount of the fee was set. I argue that the process for determining the reverse termination fee was fundamentally flawed and depicts a failure of boards to fulfill their duty to maximize shareholder value in change of control transactions.

        i. A reverse termination fee was generally set at 3% of the deal value to make it mirror the standard termination fee in an acquisition agreement; essentially this was seen as a simple cost of doing business.

        ii. The standard termination fee is the fee payable by a seller to the buyer in the event the seller terminates the agreement prior to closing. Standard termination fees typically ranged around 3% of a transaction's equity value.
            (1) Justification for Standard Break up Fees: Buyers in corporate acquisitions typically protect themselves from the risk of not completing a transaction by negotiating for the payment of a breakup fee if the seller terminates for specified reasons.
            (2) Delaware courts have said that excessive break up fees are unreasonable, although fees as high as 3.75% have been found to be reasonable.

    c. Why should the fees be set at different amounts?

        i. Significantly greater ramifications for sellers than buyers when a deal fails

        ii. Reverse termination fees should be valued as an option to allow boards to set the value at a level more commensurate with the risk to the seller of deal failure.

IV. The 2007-2009 litigations

A. Beginning in the fall of 2007 and continuing into 2008 an unprecedented number of private equity firms did just what was not expected – they attempted to terminate deals for which they could not obtain financing given the credit crisis, and, in some cases, even when financing was available.

B. Unsurprisingly, litigation ensued when private equity buyers attempted to

terminate acquisition contracts.

1. In some cases, private equity buyers argued that a material adverse change with respect to the seller had occurred so that they could walk away without even paying the reverse termination fee. In other cases, they argued that since the agreement provided for a reverse termination fee, often without a specific performance remedy, they had contracted for what amounted to an option to pay a fee for refusing and refused to close the transaction.

2. The litigation has primarily revolved around basic issues arising from incomplete contracts, or a failure of contract negotiation.

V. The Endurance of Reverse Termination Fees

A. Given the use of the reverse termination fee provision by buyers who exercised the option to walk away from the transaction, many predicted that the reverse termination fee would start to go away and seller boards would push for greater closing certainty.

B. As I indicated at the beginning, the opposite has occurred. What we have seen thus far (although I admit that deal-making has not been particularly heavy) is the rise of option-style reverse termination fees in strategic deals. In some of these deals, the reverse termination fee is set at the same level as the standard termination fee.

C. Reasons for the increasing use of reverse termination fees in strategic transactions

1. The reverse termination fee can serve as an insurance policy for buyers protecting them from such exogenous events as credit crunches.

2. We could argue that this is a good thing for sellers because there is never any absolute certainty that a deal will close, so at least the reverse termination fee gives them some compensation, without having to resort to litigation, if the deal does not close.