INSIGHTS
THE CORPORATE & SECURITIES LAW ADVISOR
Volume 21 Number 10, October 2007

STATE CORNER

The Price of Remorse: Paying Reverse Termination Fees to Excuse Performance

by John Mark Zeberkiewicz and Blake Rohrbacher

Until recently, a buyer that lost its initial enthusiasm for the target and wanted to escape from a fully negotiated merger agreement was, for all practical purposes, limited to the contractual remedy of declaring a material adverse condition (commonly referred to as a MAC). Under typical MAC clauses, targets must represent that no material adverse change or event has occurred or is continuing with respect to its business, and to the extent the target's representation ceases to be true, the buyer has the right to walk from the deal.

But escaping a deal via a MAC is not always simple. One of the principal difficulties that buyers encounter when considering whether to declare a MAC is that, no matter how broad or extensive the MAC definition, some uncertainty always will remain as to whether a court will agree with the buyer's determination (and, because a deal that a buyer views as unfavorable tends to be viewed favorably by the seller, litigation tends to follow the declaration of a MAC). Moreover, the courts have tended to read MAC clauses narrowly, requiring buyers to demonstrate that unforeseen events have caused a change in the target's long-term earnings potential.[1]

Reverse Termination Fees and Reputational Concerns

Given the limitations inherent in the MAC termination right, and in light of the fact that targets have pushed hard to eliminate the financing contingencies from most deals sponsored by financial buyers, these financial buyers have begun negotiating to limit their liability to payment of a specified fee (as opposed to providing the target with the right of specific performance) in connection with a termination of the agreement triggered by buyer's breach or failure to obtain financing. A study of 79 agreements for acquisitions of US publicly traded companies by private-equity acquirers in 2005 and 2006 revealed that 46 percent of the deals required the buyer to pay a termination fee for breach and/or failure to obtain financing.[2] Interestingly, these "reverse termination fees" have been cast as providing protection for target companies against the risk of non-consummation.[3] In fact, one key benefit of a reverse termination fee provision to the buyer is that it can be drafted to help an otherwise-breaching buyer avoid the worst-case scenario of specific performance of the deal.[4] In many cases, the buyer might be happier paying a

John Mark Zeberkiewicz and Blake Rohrbacher are associates at Richards, Layton & Finger, P.A. in Wilmington, DE. Richards, Layton & Finger may have been involved in some of the cases discussed herein, but the opinions expressed in this article are those of the authors and not necessarily those of Richards, Layton & Finger or its clients.

fixed fee than being forced to go through with a deal whose precise economic effects are unknown (but are certain to be disastrous).

In the financial-buyer context, the threat of a buyer exercising its right to walk from a deal solely on the payment of its termination fee was considered to be tempered by the countervailing risk of "reputational damage." No financial buyer, it has been argued, would be willing to terminate a deal solely because the prospect of simply paying the termination fee was more economically sound. The long-term damage to the firm's reputation, the argument goes, would outweigh any short-term benefit gained by escaping the unattractive deal. Any firm breaking a deal would suffer greatly in future deals, as its offers would potentially be viewed as presenting an intolerable amount of closing risk. As the *Wall Street Journal* has put it, "Breaking a deal presents a delicate reputational, financial and legal quandary for private-equity buyers. These firms tout their reliability to corporate boards, which depend on the buyout firms to fund and close a transaction. Backing out of a transaction could give the buyers a stigma when going before new buyout targets."[5]

Shifts in the credit market, and in the broader M&A market, could result in a shift in this dynamic. Following the credit crisis that struck in the summer of 2007, several private-equity firms have indicated publicly that they would abandon or restructure fully negotiated deals. For one example, in August, Home Depot agreed to an 18 percent price reduction in the sale of its wholesale-supply business.[6] Three private-equity buyers had originally agreed to pay $10.33 billion, but they secured a lower price of $8.5 billion[7]—and it was speculated that the reduction in price was directly linked to the buyers' rights under the MAC.[8]

Thus, it appears that some financial buyers could threaten to precipitate a termination of the deal (with liability capped at the reverse termination fee) to intimidate target companies into accepting a lower price. This does not, however, exclude the possibility that some financial buyers will exercise their full termination rights, regardless of reputational risks. A buyer's first recourse likely will be to declare a MAC and attempt to walk from the deal without penalty. When that strategy fails, however, the buyer's second line of defense against closure (assuming it has not negotiated for, or is unable to exercise, a financing out) would be to pay the reverse termination fee in connection with the termination of the deal, without the concern that the target will seek specific performance. This approach provides the financial buyer with greater certainty that the once-promising deal may be dealt with swiftly and nearly painlessly. Moreover, once one financial buyer uses its escape hatch, other financial buyers win twice—they may have more protection for using theirs and they can sell against the breaching firm.

Some concern exists in the marketplace that reverse termination fees may make deal-breaking too easy.[9] "Unlike traditional deals that let buyers out of a transaction only under a strict set of conditions, some recent deals have so-called reverse breakup fees that allow a private-equity buyer to ditch its intended partner by paying a fee that is typically no more than 4 percent of the transaction value."[10]

Reverse Termination Fees in the Delaware Court of Chancery

Given the marketplace interest in reverse termination fees, it is instructive to understand what the Delaware Court of Chancery has said about them. Unsurprisingly, the Court has not, as of yet, said much. The first appearance of the phrase "reverse break-up fee" did not appear in a Chancery Court opinion until March 2007.[11]

In June 2007, however, the Court weighed in with some skepticism on the traditional argument that financial buyers were entitled to lower reverse termination fees because of their higher reputational costs for breaking a deal. In the *Topps* case, Vice Chancellor Strine faced two competing bids for The Topps Company. Topps had signed a merger agreement with a group of financial investors led by Michael Eisner, ex-CEO of Disney; this merger agreement included a $12 million reverse termination fee.[12] Upper Deck, Topps's chief rival (and a wholly strategic buyer), outbid Eisner for Topps, insisting on a reverse termination fee of no more than $12 million.[13]

Topps argued to the Court that the "$12 million cap on liability was customary and appropriate in a transaction with a financial buyer like Eisner, [but] it was insufficient in a transaction with a strategic buyer like Upper Deck."[14] Topps pointed to the additional risks inherent in a transaction with its chief competitor, such as "regulatory obstacles and insufficient evidence of Upper Deck's "ability to finance the deal."[15] In a footnote, the Court addressed the "reputational" argument:

> 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.[16]

The discussion in *Topps* suggests that the Court of Chancery may be skeptical of lower reverse termination fees for financial buyers.[17] It is less clear what the Court thinks about reverse termination fees for strategic buyers. The *Topps* Court suggested that some strategic buyers may have the same reputational concerns: "[T]he Topps board never seems to have taken into account the reputational damage Upper Deck would suffer if it did the same [as the financial buyers], despite its knowledge that Upper Deck has acquired other businesses in the past (remember *Fleer*?) and may therefore wish to continue to do so."[18] In a more recent case, on the other hand, the Court indicated that a strategic buyer might not feel pressure to keep a bad deal. "As the Special Committee points out, there is some non-trivial risk that the Merger will go away if another vote is ordered. . . . As important, delay risks create an incentive for Mitel perhaps to conclude to move on and simply pay the $20 million reverse break fee that is the only penalty for it if it walks."[19]

Implications for Practitioners

The implications of reverse termination fees for targets and acquirers are still unclear under Delaware law. The Court of Chancery is continuing to sort out the implications of these deal-protection devices, but some general themes may be noted even at this stage. Regardless of the real-world implications of reverse termination fees—whether or not breaking a deal helps a financial buyer's competitors—the Court of Chancery is unlikely to take at face value arguments that financial buyers are entitled to lower fees because of their reputational concerns. Especially because market conditions may prove that financial buyers will cut deals loose regardless of their reputational concerns (and once each major financial buyer jettisons a deal, they are all equal again, reputationally speaking), the Court may closely scrutinize such arguments. Moreover, depending on the specific strategic buyer involved, targets may not be able to discriminate between financial and strategic buyers in setting reverse termination fees. In the current market, it remains to be seen—money may speak louder than reputation.

NOTES

1. *See In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 68 (Del. Ch. 2001) ("Merger contracts are heavily negotiated and cover a large number of specific risks explicitly. As a result, even where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror." (footnote omitted)).
2. *See* M&A Market Trends Subcomm., Section of Bus. Law, Am. Bar Ass'n, 2007 Private Equity Buyer/Public Target Mergers and Acquisitions Deal Points Study 52 (2007) (finding also that, of that subset of deals, 78 percent contained a "[c]ap on [l]iability").
3. *In re Lear Corp. S'holder Litig.*, 926 A.2d 94, 108 (Del. Ch. 2007) ("Lear was also protected in the event that AREP breached the Merger Agreement's terms by a reverse termination fee of $250 million. That fee would be triggered if AREP failed to satisfy the closing conditions in the Merger Agreement, was unable to secure financing for the $4.1 billion transaction, or otherwise breached the Agreement. But AREP's liability to Lear was limited to its right to receive this fee.").

4. *Cf., e.g.*, *IBP*, 789 A.2d at 84 (granting specific performance of a merger in which the buyer had attempted to declare a MAC).

5. Dennis K. Berman & Dana Cimilluca, "Harman's Suitors Sour on Buyout," *Wall St. J.*, Sept. 21, 2007, at A3; *see also* Lauren Silva et al., "The Pied Pipers March Off," *Wall St. J.,* Sept. 25, 2007, at C14 ("But walking away hurts [buyout shops'] reputations with two crucial constituencies: company executives and their own investors.").

6. Henry Sender et al., "Home Depot Hit As Credit Crunch Squeezes Deals," *Wall St. J.*, Aug. 27, 2007, at A1.

7. Ann Zimmerman, "Home Depot's Deal Renovation Won't Derail Big Stock Buyback," *Wall St. J.*, Aug. 29, 2007, at C3.

8. Mary Ellen Lloyd & David Enrich, "Home Depot's Supply Unit May Sell at a Lower Price," *Wall St. J.*, Aug. 10, 2007, at A2.

9. Robin Sidel & Dana Cimilluca, "Flight of the Merger 'Arbs': Risk-Takers Fear Dead Deals," *Wall St. J.*, Aug. 17, 2007, at C1 ("Adding to the concern is that some of the pending deals allow the private-equity buyers to walk away from the deal at relatively little cost.").

10. *Id.*

11. *See In re Netsmart Techs., Inc. S'holders Litig.*, 924 A.2d 171, 190 (Del. Ch. 2007) ("For its part, the Special Committee extracted a one percent reverse break-up fee payable if Insight failed to close by exercise of its financing out.").

12. *In re Topps Co. S'holders Litig.*, 926 A.2d 58, 65 (Del. Ch. 2007) ("[T]he only remedy against Eisner if he breaches his duties and fails to consummate the Merger is his responsibility to pay a $12 million reverse break-up fee.").

13. *Id.* at 73.

14. *Id.* at 72 (footnote omitted).

15. *Id.*

16. *Id.* at 72 n.11; *see also id.* at 78 ("The Proxy Statement fails to disclose, however, that Upper Deck's bid was not subject to a financing contingency. That is, Upper Deck was willing to enter into a merger agreement with Topps that would not let Upper Deck entirely off the hook in the event that it could not arrange financing. In that event, Upper Deck would be liable to Topps for the full amount of the $12 million reverse break-up fee that Upper Deck has proposed. That is the same remedy available to Topps if Eisner breaches. Topps did not make that clear. That was materially misleading.").

17. The Court of Chancery has also taken note of other arguments designed to separate financial buyers from strategic buyers on the issue of termination fees. *See, e.g.*, *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1019 (Del. Ch. 2005) ("The plaintiffs attempt to strengthen their claim by focusing on the fact that financial buyers are typically more deterred by termination fees than strategic buyers because financial buyers can't reap gains from operational synergies. But these were exactly the same universe of buyers that had already been broadly solicited at the commencement of the strategic review, and were therefore least likely to have missed out on the opportunity to bid. Indeed, eleven of those entities initially contacted remained in the final round of bidding, in one consortium or another. It is the unknown, synergistic strategic bidder that the plaintiff hopes is waiting in the wings, but such a bidder is precisely the least likely to be deterred by the existing deal protections.").

18. *Topps*, 926 A.2d at 90.

19. *Mercier v. Inter-Tel (Del.), Inc.*, 929 A.2d 786, 804 (Del. Ch. 2007).

Reprinted from *Insights* October 2007, Volume 21, Number 10, pages 22 to 25,
with permission from Aspen Publishers, Inc., a Wolters Kluwer business, New York, NY,
1-800-638-8437, www.aspenpublishers.com.