



DEAL LAWYERS

Lessons from the Meltdown: Reverse Termination Fees

By Gregory V. Varallo and Blake Rohrbacher of Richards, Layton & Finger, P.A.¹

As the economy travels its roller-coaster path, deal lawyers are constantly in danger of drafting merger provisions that deal with yesterday's problems. During the frothy "up" market that developed after the Internet bubble burst in 2000, deal lawyers paid relatively little attention to remedies provisions. Relatively few deals fell through in the go-go days of 2005 and 2006, so there were few chances for the courts to test these provisions or the processes that led to them. This changed dramatically when the market collapsed, beginning in mid-2007.

When the meltdown hit, boilerplate merger provisions (sometimes facially inconsistent with each other) suddenly took center stage. The Delaware Court of Chancery was quickly called on to address arguably facially conflicting provisions in *United Rentals*.² Litigators and deal lawyers also found themselves navigating their clients through deal divorces involving so-called "reverse termination fees." All within a few months, a series of up-market deals moved through the courts: Clear Channel endured litigation in multiple state courts,³ BCE litigated issues all the way to the Canada Supreme Court,⁴ and Huntsman found itself in a dogfight with Apollo/Hexion in courts in Texas and Delaware.⁵

Drawing lessons from the continuing economic contraction in the deal market, we focus here on the use of reverse termination fees.⁶ These are generally specified fees payable by a buyer "in connection with a termination of the [merger] agreement triggered by buyer's breach or failure to obtain financing."⁷ Others have discussed, in part, the question whether these fees make sense.⁸ We address that point briefly in the context of the deal meltdown, and then we address whether current practice in negotiating reverse termination fees needs to change.

The "Virtues" of Reverse Termination Fees

In 2005 and 2006, reverse termination fees had become common in many transactions—particularly in acquisitions by private-equity acquirers. One study found that nearly half of private-equity acquisitions in 2005 and 2006 of publicly traded U.S. companies involved reverse termination fees.⁹ The pace increased in 2006 and 2007. We did a quick review of recent going-private transactions and found that nearly all involved a reverse termination fee. In most of those transactions, the reverse termination fee was the exclusive remedy (as opposed to specific performance) for the buyer's failure to close or failure to have financing.

Reverse termination fees' popularity was easy to explain: both parties wanted them. Sellers liked reverse termination fees because the fees were believed to increase deal certainty.¹⁰ That is, for sellers, these provisions were thought to serve as an "insurance policy" that a buyer would go forward with a transaction. Buyers, which often coupled such clauses with "exclusive remedy" provisions, liked them for a different and contradictory reason. From the buyer's perspective, the fees served as a worst-case scenario (provided, of course, that the fee was structured as

¹ Gregory V. Varallo is a director, and Blake Rohrbacher an associate, at Richards, Layton & Finger, P.A., Wilmington, Delaware. 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.

² *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810 (Del. Ch. 2007).

³ Suits in New York and Texas were settled in May 2008. See Press Release, Clear Channel Commc'ns, Inc., <http://www.clearchannel.com/Corporate/PressRelease.aspx?PressReleaseID=2206> (May 13, 2008).

⁴ *BCE Inc. v. A Group of 1976 Debentureholders*, No. 32647 (Can. June 20, 2008) (judgment in appeal), available at http://scc.lexum.umontreal.ca/en/news_release/2008/08-06-20.3/08-06-20.3.pdf.

⁵ See, e.g., *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 2008 WL 4457544 (Del. Ch. Sept. 29, 2008).

⁶ This is the first in what we hope is a series of articles addressing issues that have arisen as a result of the recent disruption in the M&A market.

⁷ John Mark Zeberkiewicz & Blake Rohrbacher, *The Price of Remorse: Paying Reverse Termination Fees to Excuse Performance*, Insights, Oct. 2007, at 22, 22.

⁸ See, e.g., Robin Sidel & Dana Cimilluca, *Flight of the Merger 'Arbs': Risk-Takers Fear Dead Deals*, Wall St. J., Aug 17, 2007, at C1; Zeberkiewicz & Rohrbacher, *supra* note 6.

⁹ 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 that 46% of such deals involved reverse termination fees).

¹⁰ See Zeberkiewicz & Rohrbacher, *supra* note 6, at 22; see also *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.")

the exclusive remedy for a seller).¹¹ That is, a buyer that could avoid specific performance “might be happier paying a fixed fee than being forced to go through with a deal whose precise economic effects are unknown (but are certain to be disastrous).”¹²

What Went Wrong?

Reverse termination fees were therefore often accepted as standard deal terms and subject to little pushback from either side. Then the bottom fell out of the market and perceptions quickly changed.

Sellers in particular were caught short by the new market reality. Rather than forcing recalcitrant buyers to go forward with deals, reverse termination fees gave buyers a welcome way out of transactions, even if it meant paying tens, or even hundreds, of millions of dollars in fees. For buyers, compared to a market with no available liquidity, an inability to syndicate transaction debt, and resulting immediate writedowns often in the billions, the loss of even hundreds of millions was seen as potentially acceptable or, occasionally, preferable.¹³ Reverse termination fees coupled with exclusive-remedy provisions became a clear (if expensive) way out, and a surprising number of buyers took the opportunity to exit deals. Furthermore, an (unsophisticated) analysis of the empirical evidence suggests that the markets are not kind to jilted sellers, even months after the transaction terminations are announced.¹⁴

What happened? Was everyone simply naïve in thinking that reverse termination fees were helpful? Why didn't these provisions work as planned? The simple answer—that the merger agreements, though built to withstand mild turbulence, were simply unable to handle the market's perfect storm—is probably incomplete.

The best answer may be that practitioners' frameworks were wrong. That is, deal lawyers were (incorrectly) thinking about reverse termination fees in the framework of standard termination fees, when really the two are unrelated.

As a matter of pure economics, every deal could theoretically be structured with a reverse termination fee so high that the buyer would almost invariably agree to proceed (absent the occurrence of an MAE or some other contracted-for exit). Whether or not enforceable as a matter of public policy, a 100% reverse termination fee provision, for example, would likely have 100% success in protecting the merger. On the other hand, a .001% reverse termination fee would likely do very little to hold a buyer in contract, especially when the deal is large and the markets are troubled.

Practically, though, buyers likely would not agree to a 100% reverse termination fees, and sellers likely would not agree to a .001% reverse termination fees. But why not? The answer lies in the genesis of reverse termination fees.

As these fees developed, they were typically negotiated as the inverse of their namesake, the “forward break-up fee.” Buyers constrained by fiduciary law to a break-up fee of no more than 3% or 3.5% of the deal value¹⁵ were rarely willing to give sellers higher reverse termination fees. As a matter of custom, the two fees were typically negotiated together, and negotiators—often faced with more difficult and seemingly important provisions to negotiate—did not make it a priority to decouple the negotiation of the two provisions. Our review of recent going-private transactions suggests that reverse termination fees are quite often negotiated to be identical to the forward break-up fee.¹⁶

But the two fees, though similar in name, are *not* the inverse of each other. In fact, the two provisions serve very different purposes, and, we submit, it is the failure to appreciate this fact that has led to a breakdown in the usefulness of reverse termination fees in these turbulent market conditions.

¹¹ Zeberkiewicz & Rohrbacher, *supra* note 6, at 22.

¹² *Id.* at 22–23.

¹³ See, e.g., *Hexion*, 2008 WL 4457544, at *3 (noting that plaintiff-buyer sought a declaration that “its liability to [seller] for failing to close is limited to no more than \$325 million”).

¹⁴ Before the September 2008 market disruptions, the two-year stock charts of companies like Harman International Industries (HAR), SLM Corp. (SLM), United Rentals (URI), and Acxiom Corporation (ACXM) all exhibited a similar mesa-like pattern: the stocks climbed sharply upon announcement of the transaction, dropped sharply upon the announced termination of the deal, and did not return to pre-deal levels.

¹⁵ See, e.g., *La. Mun. Police Employees' Ret. Sys. v. Crawford*, 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007) (citing cases).

¹⁶ See also Houlihan Lokey, *2007 Transaction Termination Fee Study* 18 (Sept. 2008) (finding that roughly 60% of transactions with reverse termination fees had identical reverse and forward break-up fees).

Forward break-up fees were originally developed as a consolation prize, a payment to a buyer in contract when the seller received and eventually accepted a “superior proposal.”¹⁷ In Delaware, at least, the law has been clear that a seller may never shut itself off to unsolicited proposals to purchase the company on terms superior to the existing transaction.¹⁸ Doing so would impermissibly favor transaction certainty over stockholder return, which Delaware public policy forbids in this context.¹⁹

Thus, the courts faced two competing interests when deciding issues regarding forward break-up fees. On one hand, the courts had to allow fees high enough to compensate buyers for, essentially, putting their bids at risk as “stalking horses” in certain situations. On the other hand, courts wanted to keep fees low enough that sellers could still attract available and bona fide superior proposals from bidders willing to pay the costs of breaking up the transaction. The intersection of these two principles has resulted in a range of comfort for transactional planners. While the Court of Chancery has recently emphasized that there is no forward break-up fee that will “automatically” be subject to approval if challenged,²⁰ the cases demonstrate that forward break-up fees up to 3% or 3.5%, when challenged, have consistently been approved.²¹ But the same does not necessarily apply to reverse termination fees.

Reverse termination fees are meant to promote certainty of contract by anchoring an existing bidder into a deal. But where a reverse termination fee is negotiated as the inverse of a forward break-up fee, its intended purpose is almost doomed to failure at the outset. A buyer facing the kind of market turbulence currently extant will often (quite logically) prefer paying a 3% exit fee to putting disproportionate amounts of its available capital at risk in a single transaction.

Fiduciary Constraints on Reverse Termination Fees

What of a buyer’s argument that certainty of contract is a two-way street and that it need not give more in a reverse termination fee than it receives in a forward break-up fee? The answer is this: the body of fiduciary law guiding the size of a forward break-up fee has no application to a reverse termination fee. When market participants ignore that fact (either intentionally or accidentally), we make contracts that don’t weather market storms.

Simply put, reverse termination fees do not directly implicate the same fiduciary concerns that animate the dispute over forward break-up fees. This is true for two principal reasons: First, sellers’ boards of directors do not violate their *Revlon* duties by negotiating high reverse termination fees, so long as they do so consistently with obtaining the highest price available to the stockholders.²² That is, reverse termination fees—unlike forward break-up fees—do not come at the expense of sellers’ stockholders. Second, sellers’ boards of directors should not face *Unocal* enhanced scrutiny regarding reverse termination fees (all other things being equal), because such fees lock only the *buyer* into the deal. Sellers’ stockholders are not precluded by reverse termination fees from taking or considering other proposals.²³ Similarly, large reverse termination fees do not impede the emergence of unsolicited third-party bidders. Of course, buyers’ directors have fiduciary duties as well, and buyers’ boards must take those duties into account before agreeing to reverse termination fees. But the standard deal-protection analysis focuses on the sellers’ directors.

¹⁷ Cf., e.g., *McMillan v. Intercargo Corp.*, 768 A.2d 492, 505 (Del. Ch. 2000) (“[T]he termination fee was structured so as to be payable only in the event that the Intercargo stockholders rejected the XL merger and were benefited by a more favorable strategic transaction within ninety days or another acquisition proposal within the ensuing year.”); *Kontrabecki Group, Inc. v. Triad Park, LLC*, 1998 WL 1809924, at *2–3 (Del. Ch. Mar. 17, 1998) (TRANSCRIPT).

¹⁸ See, e.g., *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 938 (Del. 2003).

¹⁹ See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986).

²⁰ See *Crawford*, 918 A.2d at 1181 n.10 (“Though a ‘3% rule’ for termination fees might be convenient for transaction planners, it is simply too blunt an instrument, too subject to abuse, for this Court to bless as a blanket rule.”).

²¹ *Id.*

²² See *Revlon*, 506 A.2d at 182 (holding that the directors’ role in a change-of-control situation is to ensure that they are “getting the best price for the stockholders”).

²³ Forward break-up fees, on the other hand, are scrutinized to determine whether they would preclude or stifle other bids. See, e.g., *QVC Network, Inc. v. Paramount Commc’ns Inc.*, 635 A.2d 1245, 1262 (Del. Ch. 1993), *aff’d*, 637 A.2d 34, 49–50 (Del. 1994); *In re Holly Farms Corp. S’holders Litig.*, 1988 WL 143010, at *6 (Del. Ch. Dec. 30, 1988) (“The termination fee and reimbursement provisions of the Merger Agreement also appear likely to have been part of the effort to preclude a genuine auction.”).

Practical Implications: Negotiating Reverse Termination Fees

Because reverse termination fees are not judged by the same criteria that limit forward break-up fees, market participants have several ways in which to address the market failure of the standard reverse termination fees.

First, deal counsel should consider the fact that they are not serving their clients by negotiating the two fees in tandem. Accordingly, a new approach should be developed, in which the fees are separately negotiated. In saying this, of course, we recognize that bucking an established trend in negotiation practice, even where that established trend may not serve the client's interest, is often difficult.

Second, the fees themselves must not only be decoupled from forward break-up fees but also must be calibrated to their intended use. While unusual, perhaps consultation with a competent economist during the course of negotiations would be of use. After all, as talented as deal lawyers can be, we are not equipped by virtue of our legal training with skills that would lend themselves to calibrating properly the size of such a fee. To say it must be "larger than the forward break-up fee" is a starting place, but no more.

Third, if the paired-fee approach were to be seen as too sacrosanct to alter, deal counsel should consider decoupling reverse termination fees from the typical exclusive-remedy provision. Doing so would likely inject enough litigation uncertainty into a recalcitrant buyer's calculation to function as an incentive to close. A review of recent transactions suggests that specific performance may either be allowed for certain portions of a merger agreement (such as enforcing the Parent vote) or be allowed to compel closing, but only if financing is available. Creative lawyering regarding some level of specific performance, in addition to a reverse termination fee, may yield merger agreements that can withstand the downs—as well as the ups—in the market. But that, of course, remains to be seen.

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Publisher: **Jesse M. Brill**. Formerly an attorney with the Securities and Exchange Commission and a leading authority on executive compensation practices, Mr. Brill is the Publisher/Editor of *The Corporate Counsel*, Chair of the National Association of Stock Plan Professionals, CompensationStandards.com and DealLawyers.com.

Editor: **Broc Romanek**, former SEC attorney and Editor of DealLawyers.com and TheCorporateCounsel.net. Broc can be reached at broc@deallawyers.com.

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DealLawyers.com • P.O. Box 21639 • Concord, CA 94521-0639 • (925) 685-5111 • Fax (925) 930-9284 • info@DealLawyers.com
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