Breakup Fees — Picking Your Number

Historical ranges for breakup fees may have value as one reference point, but a nuanced, fact-specific and tailored approach to setting a breakup fee is required for each deal.

During the course of negotiations of every public company deal, inevitably the conversation will turn to the amount of the breakup fee payable by a target company to a buyer if the deal is terminated under certain circumstances. Because U.S. corporate law generally requires a target company to retain the ability to consider post-signing superior proposals, a breakup fee is an important element of the suite of deal protection devices (including "no-shop" restrictions, matching rights, etc.) that an initial buyer implements to seek to protect its position as the favored suitor. Speaking broadly, a breakup fee will increase the cost to a topping bidder as it will also need to cover the expense of the fee payable to the first buyer. However, with respect to deal protection terms in general, as well as the amount of breakup fees in particular, courts have indicated that they cannot be so tight or so large as to be preclusive of a true superior proposal. Starting from this somewhat ambiguous principle, the negotiations therefore turn to the appropriate amount for the breakup fee given the particular circumstances of the deal at hand.

Unquestionably, precedent often informs the discussion, and there is a significant amount of statistical data to back up a general proposition that fees "usually" fall in the 3% to 4% range. A variety of studies has shown that median termination fees as a percentage of transaction or equity value consistently fell between 3.2% and 3.4% over the course of the last four years. Fees measured by enterprise value have been similarly stable between 3.1% and 3.3% over the same period. Studies have also shown that, as deal size goes up, fees, measured on a percentage basis, tend to go down. This inverse correlation between deal and fee size is probably a function of the optics resulting from the absolute, rather than relative (percentage), amount of the fees in megadeals. As then VC Strine admonished in the *Toys "R" Us* decision, regardless of historical precedent for accepted ranges, when dealmakers are working with very large numbers they can run afoul of the "preclusive differences between termination fees starting with a 'b' rather than an 'm'."

While the statistical data have some baseline value, not least because of their consistency over long periods of time, dealmakers should be cognizant that the Delaware courts have resisted providing a bright line or range test for reasonableness of breakup fees. In a relatively consistent set of rulings, Delaware courts have upheld breakup fees falling within the statistically-supported 3% to 4% range (*e.g.*, 3% in *Cogent*, 3.3% in *MONY*, 3.75% in *Toys "R" Us* and 4.3% in *Topps*). On a few of the rare occasions when a Delaware judge looked at a fee outside that range, the court upheld a 4.4% fee describing it as "near the upper end of a 'conventionally accepted' range" (*Answers*) and criticized a 6.3% fee (*Cyprus Amax*) noting that it "seems to stretch the definition of range of reasonableness … beyond its breaking point." That said, the Delaware courts have regularly taken the position that the acceptability of a breakup fee is a highly fact specific inquiry, not a function of consistency with statistical ranges. In *Caremark*, then Chancellor Chandler pointed to a number of factors that the court will consider, including "the overall size of the termination fee, as well as its percentage value; the benefit to shareholders, including a premium (if any) that directors seek to protect; the absolute size of the transaction, as well as the relative size of the partners to the merger; the degree to which a counterparty found such protections to be crucial to the deal, bearing in mind differences in bargaining power; and the preclusive or coercive power of all deal protections included in a transaction, taken as a whole." The court further drove the point home by saying that "the inquiry, by its very nature fact intensive, cannot be reduced to a mathematical equation."

Beyond the simple question of the percentage of the breakup fee, parties will often discuss the appropriate denominator for the exercise — specifically whether it is measured as a percentage of equity value or of enterprise value. As to this question, the Delaware courts generally have taken a similar fact-specific approach. The court has avoided stating that one metric is appropriate to all situations. While most of the cases addressing breakup fees have focused on the percentage of transaction (equity) value and VC Noble has stated that Delaware law has "evolved by relating the break-up fee to equity value" (*Answers*), in certain circumstances the courts have addressed the question of whether enterprise value is a more logical metric. For example, in *Cogent*, where the target company had a significant net cash balance, the court rejected claims by plaintiffs that what appeared to be a 3% fee was really a greater than 6% fee because enterprise value (*i.e.*, excluding cash) was the appropriate denominator. In rejecting that position, VC Parsons stated that the cash should be included in the denominator because the buyer was purchasing all of the target's assets including the cash. A similar approach formed the basis of the decision in *Dollar Thrifty* where the court held that the amount of a one-time special cash dividend payable to target shareholders immediately before closing was appropriately included in the denominator when evaluating the fee in that case. On the other hand, in *Lear*, then VC Strine indicated that enterprise value was arguably more important than equity value in that particular situation because of the target's significant net debt balance that had to be accounted for (and ultimately assumed or repaid by the buyer). In his recent *Synthes* decision, Chancellor Strine returned to this theme describing enterprise value as "typically the more relevant measure for assessing the preclusive effect of a termination fee" even in this case where the target had very little net debt. Perhaps the somewhat divergent guidance in these decisions was best captured by VC Parsons in *Cogent* when he stated that the court has not held that "enterprise value should replace equity value as the proper metric, but only that it might sometimes (within the context of a highly leveraged transaction, for example) be appropriate."

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Despite the surface appeal of relying on statistical and court precedent, dealmakers must resist the temptation to rely solely on these data. The amount of a breakup fee is not a matter that can be viewed in isolation from other factors such as the other deal protection devices (including any separate expense reimbursements), the circumstances in which the fee is payable and the history of the sale process. Historical ranges may have value as one reference point for a discussion, but a more nuanced, fact-specific and tailored approach to setting a breakup fee is required for each deal.

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