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RESPONSE TO THE COST OF GUILTY BREACH: WHAT WORK IS "WILLFUL BREACH" DOING?

BRIAN JM QUINN*

In this Response, Professor Brian Quinn comments on *The Cost of Guilty Breach: Willful Breach in M&A Contracts*.[1] That Essay can be found here.

RESPONSE

The authors of *The Cost of Guilty Breach* have pointed out an interesting issue—why is it that merger agreements import into their contracts language of moral culpability to establish liability in connection with a breach of the agreement? The authors propose some persuasive hypotheses to explain the presence of "willful breach" language. In this brief response, I mostly agree with the authors and offer a few of my own thoughts about the merger contract and breach.

As the authors note, merger agreements typically include "termination fees." Although the courts will examine termination fees using the language of liquidated damages, strictly speaking they are not liquidated damages payable upon a breach of the contract.[2] Termination fees are best understood as negotiated fees payable when the contract is terminated pursuant to its terms, rather than in the context of a breach. Where parties are in *actual breach*, termination provisions do not come into play at all. Indeed, merger agreements typically

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[1] Theresa Arnold, Amanda Dixon, Madison Whalen Sherrill, Hadar Tanne & Mitu Gulati, *The Cost of Guilty Breach: Willful Breach in M&A Contracts*, 62 B.C. L. REV. E. SUPP. I.-32 (2021), http://lawdigitalcommons.bc.edu/bclr/vol62/iss9/23/ [https://perma.cc/Y9Q4-XJEW].

[2] Brazen v. Bell Atl. Corp., 695 A.2d 43, 48 (Del. 1997) (describing the two-part test to determine the validity of termination fee provisions: first, that damages that would result from a breach of the merger agreement must be uncertain or incapable of accurate calculation, and second, that the size of the fee is not unreasonably large as to constitute a penalty (quoting Lee Builders, Inc. v. Wells, 103 A.2d 918, 919 (Del. Ch. 1954)). Although *Brazen v. Bell Atlantic Corp.* purportedly applied the standard test for liquidation provisions, it did so with a decidedly corporate law skew, relying heavily on the language of *Unocal Corp. v. Mesa Petroleum Co.* to determine whether the size of the fee was "within a range of reasonableness." *Id.* at 48–49; *see* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) ("If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed."). Subsequently, courts have explicitly applied *Unocal*'s intermediate standard to its evaluation of termination fees as deal protection measures in merger agreements. *See, e.g.*, *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 997, 1000 (Del. Ch. 2005).

attempt to limit remedies to specific performance, rather than expectation damages or any other form of damages.[3] Because termination fees do not involve actual breach, the circumstances in which such fees are payable are relatively limited and entirely foreseeable by the parties.

Termination fees come in one of two basic types: fiduciary termination fees, paid to the buyer by the seller, and reverse termination fees, paid to the seller by the buyer. Fiduciary termination fees are payable to the buyer by the seller in the event a seller's fiduciary duties require its board to terminate the incumbent transaction to enter into an alternative transaction that is materially better for the shareholders than the incumbent merger. Because directors are generally prohibited from entering into merger agreements that do not include fiduciary termination rights, such rights are commonplace in merger agreements, as are attendant termination fees.[4]

Although termination fees are common, they do not attempt to mimic expectation damages. Indeed, judicial constraints on their amount make it impossible for transaction planners to gauge the size of termination fees to an actual estimate of the buyer's damages in the event the seller terminates the transaction to pursue a superior alternative. This is because a large fiduciary termination fee can act to deter subsequent bids—to be successful, a subsequent bidder's valuation of the target must exceed the deal price plus the value of any fiduciary termination fee payable by the seller upon a termination. The larger the termination fee, the less likely a subsequent bidder will be able to outbid the incumbent purchaser. Where a termination provision is so large as to deter subsequent bids, however, a board may violate its fiduciary duties by agreeing to it.[5] Consequently, termination fees are usually capped at approximately three percent of deal value, which likely bears no relation to expectation damages, but does represent a judicially determined amount that is not so large as to deter a subsequent bid.

The second type of termination fee common in merger agreements is the reverse termination fee. The reverse termination fee is paid by the buyer to the seller in the event the merger cannot be completed due to one of a small number of possible reasons, including failure to gain regulatory approval (antitrust, for example) or financing.[6] Obviously, in the event regulatory approval is not forthcoming, specific performance is not going to be available as a remedy.

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[3] Theresa Arnold, Amanda Gray Dixon, Hadar Tanne, Madison Whalen Sherrill & Mitu Gulati, *Lipstick on a Pig: Specific Performance Clauses in Action*, 2021 WIS. L. REV. (forthcoming) (analyzing the use of specific performance remedies in merger agreements).

[4] Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d. 914, 938 (Del. 2003) (holding that when boards enter into merger agreements that do not permit them to consider superior alternatives, they violate their fiduciary duties).

[5] *See Toys "R" Us*, 877 A.2d at 1014–22 (discussing how excessive termination fees may preclude higher bids).

[6] Brian JM Quinn, *Optionality in Merger Agreements*, 35 DEL. J. CORP. L. 789, 813 (2010).

The reverse termination fee is an attempt to compensate the seller for the seller's damages if it is left at the veritable merger altar. Often, for symmetry and ease of negotiation, these fees are set at the same size as the seller's termination fee. With the seller's fee judicially constrained, however, using symmetry to set the reverse termination fee is never going to reflect an adequate estimate of actual damages. Because the reverse fee is not judicially constrained in the same way the termination fee is, it can be, and often is, larger than the typical termination fee.[7] Sometimes, parties set larger reverse termination fees as part of a legitimate effort to estimate reasonable damages to the seller in the event they are jilted by the buyer due to a regulatory hurdle. In other circumstances, buyers use outsized reverse termination provisions to signal to antitrust authorities their determination to get the deal done (Google and Motorola Mobility, for example).[8]

Before the 2008 financial crisis, some private equity buyers triggered reverse termination fees due to their inability to arrange financing for the transaction. Where contracts limited remedies in the event of financing failure to the reverse termination fee, this effectively turned the merger agreement into a call option for the buyer.[9] Today, the use of reverse termination fees in this manner is much less common. Like reverse termination fees in the context of government approvals, those tied to financing conditions work to compensate jilted sellers in the event financing is not forthcoming, as well as to incentivize buyers to expend efforts to meet the financing condition. I will limit the balance of my comments on reverse termination fees to just reverse termination fees involving regulatory approvals.

The authors of *The Cost of Guilty Breach* point to what is likely the motivation for the willful breach language in termination provisions. More likely than not, the willful breach language represents an attempt to smoke out pretextual rationales for buyers not completing an acquisition. Remember, failure to meet, for example, the regulatory condition is not a breach of contract in and of itself. Rather, failure to achieve regulatory approval leads to a negotiated right to terminate the contract, pursuant to its terms. Why? Because failure to

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[7] *Id.* at 809.

[8] In 2012, Google agreed to pay Motorola Mobility a reverse termination fee equal to $2.5 billion (approximately twenty percent of deal value) in the event antitrust authorities did not approve the transaction. The large size of this fee signals to antitrust authorities that the buyer is determined to push a deal through and will be willing to fight the government to avoid becoming liable for a large reverse termination fee payment. *See* Shira Ovide, *Google-Motorola Merger Agreement: The Highlights*, WALL ST. J. (Aug. 18, 2011), https://www.wsj.com/articles/BL-DLB-34387 [https://perma.cc/VK5M-MAY7].

[9] Quinn, *supra* note 6, at 813; *see also* Steven Davidoff Solomon, *The Private Equity Contract*, *in* THE OXFORD HANDBOOK OF PRIVATE EQUITY 15, 16 (Douglas Cumming ed., 2012). In *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, the buyer attempted to walk away from the seller in part because the buyer was unable to arrange financing for the purchase due to fragility of global credit markets. 965 A.2d 715, 721 (Del. Ch. 2008).

obtain regulatory approval is a semi-exogenous variable in the deal making process. To the extent approval or denial of regulatory approval stems from national policy, whether such approval is forthcoming is outside the control of either buyer or seller. In that sense, it is an exogenous contractual condition, failure of which does not necessarily suggest any level of fault by either party. The authors of *The Cost of Guilty Breach* recognize this and suggest failure of a regulatory approval condition might be innocent.

On the other hand, whether regulatory approval is forthcoming is also a function of the level of effort the parties decide to exert in the process of seeking approval. A reluctant buyer might decide to negotiate less aggressively with regulatory authorities, or might foot-drag with respect to filing requirements and thus impede the approval process. To the extent regulatory approvals are dependent on the efforts of the buyer to the transaction, this condition is endogenous. The authors characterize—and rightly so—failure to obtain government approval due to insufficient efforts on the part of the buyer as a guilty breach.

And it is here where we begin to understand the role of willful breach in the merger contract. Willful breach, in this context, is not a moral judgment on the buyer's behavior, but rather an attempt to smoke out buyer pretext.

Remember, because reverse termination fees are often symmetrical with termination fees in size, they often do not even vaguely attempt to compensate buyers for actual harm caused by a failure to gain regulatory approval. If a remorseful buyer decided that rather than complete the acquisition it need only foot-drag on regulatory approval and then pay the reverse termination fee to terminate the contract pursuant to its terms, then the reverse termination fee would convert the merger contract into an option contract.

The presence of willful breach gives sellers another lever to police buyer efforts. Where the regulatory approval process fails, before a buyer may terminate the transaction pursuant to its terms, the seller is permitted to test the buyer's motivation. Take, for example, the recent acquisition of Tiffany by LVMH.[10] The deal was announced in November 2019, but following the onset of COVID-19, LVMH began to get cold feet.[11] As is common, various regulatory approvals were conditions of the transaction and both buyer and seller committed to expend their "reasonable best efforts" to secure these approvals.[12] Although the transaction did not include a reverse termination fee (they

[10] Agreement and Plan of Merger Among Tiffany & Co., LVMH Möet Hennessy-Louis Vuitton SE & Breakfast Acquisition Corp. (Nov. 24, 2019), https://www.sec.gov/Archives/edgar/data/98246/000119312519299997/d840067dex21.htm [https://perma.cc/TF2X-YFSQ].

[11] Carol Ryan, *LVMH Has Reasons to Get Cold Feet over Tiffany*, WALL ST. J. (June 3, 2020), https://www.wsj.com/articles/lvmh-has-reasons-to-get-cold-feet-over-tiffany-11591189844 [https://perma.cc/7QLD-YJLQ].

[12] Plan of Merger, *supra* note 10, § 7.3(b).

are less common in strategic acquisitions), it did include the willful breach language.[13] In the event the parties reached the outside date for the transaction and government approval was not forthcoming, LVMH would be permitted to terminate the transaction pursuant to its terms and walk away without paying a fee. How then to interpret a mysterious letter from French government agency that described the French government's desire that LVMH delay closing the merger until after the transaction's drop-dead date as anything other than a pretext intended to permit LVMH to walk away without breaching the contract?[14]

Willful breach gives the seller a contractual tool to police pretexts where buyers, like LVMH, engage in foot-dragging to avoid closing. If the seller is able to establish willful breach, then the seller can rely on the contract's remedies clause to seek specific performance to move the buyer to close, notwithstanding the buyer's cold feet.[15] In the absence of willful breach language, a buyer's cold feet would allow the buyer to point to pretexts and transform the merger agreement into little more than an option contract that permits the buyer to pay a fee and walk away when the buyer develops remorse post-signing (or in the case of LVMH, pay nothing).

Though willful breach may suggest moral judgment, its use in merger agreements merely cabins the ability of buyers to terminate the agreement pursuant to its terms and reins in the ability of buyers to look to pretextual excuses to avoid performance.

The Cost of Guilty Breach's close read of merger contracting practices is an excellent addition to the series of papers this group of authors has written on contract theory and the merger contract. Hopefully, they are not done yet.

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[13] *Id.* §§ 1.1, 9.5(c). The merger agreement included the following definition:

> "Willful Breach" means, with respect to any representation, warranty, agreement or covenant, an action or omission taken or omitted to be taken that the breaching party intentionally takes (or intentionally fails to take) and knows (or reasonably should have known) would, or would reasonably be expected to, cause a material breach of such representation, warranty, agreement or covenant (regardless of whether breaching was the object of the act or omission).

Id. § 1.1. "Willful Breach" is then used in the termination provision. *Id.* § 9.5(c).

[14] Flavia Krause-Jackson, *LVMH's Arnault Leaned on Government to Exit Tiffany Deal*, BLOOMBERG (Sept. 9, 2020), https://www.bloomberg.com/news/articles/2020-09-09/lvmh-s-arnault-leaned-on-french-government-to-exit-tiffany-deal [https://perma.cc/PH28-DB7L]; *see also French Government Request That LVMH Delay Tiffany Deal Was Only Advice—Source*, FIN. POST (Sept. 9, 2020), https://financialpost.com/pmn/business-pmn/french-government-request-that-lvmh-delay-tiffany-deal-was-only-advice-source-2 [https://perma.cc/XTT8-8S2L].

[15] *See, e.g.*, *In re* IBP, Inc. S'holder Litig., 789 A.2d 14, 83–84 (Del. Ch. 2001).