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Commercial Law

Break fees – issues for corporate lawyers

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Until recently, the payment of break fees (also known as termination, inducement or broken-deal fees) was uncommon on UK transactions, although they have featured in US takeovers for a long period. However, they are becoming more popular and have featured in a number of major transactions, including the BP/Amoco merger. Successful implementation of break-fee arrangements gives rise to a number of UK corporate law and regulatory issues, and market practice in this area is developing.

CODE APPLIES

The Takeover Code applies where the target company is a UK plc. The Takeover Panel, which oversees regulation of takeovers in the UK, will act to ensure that the target's shareholders are not adversely affected by break fee arrangements, since these will necessarily reduce offeree shareholders' funds.

Under a typical break-fee arrangement, one party to a takeover (usually the target but sometimes a major shareholder in the target) will agree at the outset of the transaction to pay a fee if the transaction does not proceed. Circumstances in which this type of arrangement will take effect include the following:

(1) the target board withdraws its recommendation for a transaction;

(2) the target board recommends a proposal by a third party;

(3) the acquisition proposal lapses because of

(a) a merger reference;
(b) unsatisfactory due diligence;
(c) the target board takes prohibited steps (e.g. negotiates with a competing bidder).

The commercial rationale for payment of break fees has been questioned but they can provide certainty for a target company by tying in the offeror to the sale process and, from the offeror's point of view, provide a degree of comfort and help to minimise the risk of being outbid by a third party. They can also provide assurance of payment of the very large professional fees, advisory costs and management time which can be involved in takeovers and mergers.

LEGAL ISSUES

The effect of paying a break fee is to move the risk of failure of the bid from the offeror to the target and ultimately the target's shareholders. It can also be argued that payment of such fees may not be commercially necessary since a bona fide bidder will proceed with the transaction if it is in its commercial interests to do so. Where a rival bid is successful, the successful bidder may seek to challenge payment of any break fee or attempt to make the directors of the target company who agree to the arrangement personally liable. These risks mean that careful structuring of break fees is required and a number of legal issues arise.

Directors' duties

In deciding whether to pay a break fee, the target's directors must balance the interest of the company in ensuring that the offer proceeds against the possible deterrent effect of the fee arrangement on the making of rival offers and the cost to the company if a break fee has to be paid. To carry out their duty to exercise their judgment in an informed and independent fashion, and to act in the company's best interests, directors must be particularly careful to ensure that they are not acting for a collateral purpose, for example, treating the break fee as a means of discouraging an unwelcome, competing bidder – which would be a misuse of the board's powers. The directors should also ensure that the fee is reasonable and the lowest that the directors can negotiate in the circumstances. In the situation where there is more than one offer outstanding, the company must consider the interests of the current shareholders and recommend the offer which provides them with the best price for their shares.

The directors must also ensure that they do not fetter their discretion in advising shareholders as to the merits of any potential competing offer. This will largely be a matter of the size of the fee in question. It is thought unlikely that a court would hold a break fee of less than 1 per cent of the target's net assets to be large enough to restrict the directors' ability properly to advise.

Financial assistance

The *Companies Act* 1985 ('CA 85') prevents a company or any of its subsidiaries from giving financial assistance directly or indirectly for the purpose of helping another person to acquire its shares (s. 151–158). A 'whitewash' procedure is available under which private companies can give financial assistance, but this is not available to plcs. Breach of the prohibition is a criminal offence on the part of directors, and financial assistance will render an agreement unenforceable.

COMMERCIAL RATIONALE

The commercial rationale for payment of break fees has been questioned but they can provide certainty for a target company by tying in the offeror to the sale process and, from the offeror's point of view, provide a degree of comfort and help to minimise the risk of being outbid by a third party. They can also provide assurance of payment of the very large professional fees, advisory costs and management time which can be involved in takeovers and mergers.

The first issue in relation to break fees is whether the financial assistance provisions are relevant at all, given that payment of the fee will normally take place in circumstances where an offer has failed and no acquisition of shares has

taken place. Although the point is untested in the courts the arrangement should be assessed at the time when the potential financial assistance is given, i.e. when the arrangement is entered into, as there might be judged to be financial assistance even where the attempted acquisition has failed.

In addition to the whitewash procedure for private companies, there are a number of exemptions from the prohibition on the giving of financial assistance. These include cases where the company's principal purpose in giving the assistance is not to give it for the purpose of the acquisition, but is an incidental part of some larger purpose and is given in good faith in the interests of the company (s. 153(1)(a), CA 85). However, the courts have held that this exemption only applies where there is a corporate act on the part of the company giving the financial assistance and the target's role in the transaction may well be passive.

The types of financial assistance likely to be relevant to break fee arrangements are financial assistance by way of gift, financial assistance given by way of guarantee, security or indemnity and other types of financial assistance given by a company which either has no net assets or which, as a result, has its net assets reduced to a material extent (s. 152(1), CA 85).

It would be unusual for break fees to be paid by way of gift. They will often be expressed to be paid by the target in consideration of the offeror incurring costs by proceeding with the bid – and in these circumstances no question of a gift arises. However, if the sum which the target agrees to pay the offeror is calculated by reference to the costs incurred by the offeror in making the offer, it will be classified as an indemnity. One way of avoiding this is for the parties to agree at the outset a pre-determined fixed fee, which is negotiated independently of any expectation as to the offeror's costs and which is not then adjusted by reference to the costs incurred by the offeror. This should allow the transaction to be classified as an inducement for the offeror to take forward the opportunity of making the offer rather than as an indemnity given by the target. (In this context a distinction can be drawn between large trade purchases and MBO-type situations, which arise on 'public to private' transactions where listed companies are taken private by means of a management buy-out. In the latter situation the directors may be unwilling and unable to fund the bid without the promise of a break fee. However, although a break fee may induce a large buyer to make an offer it arguably may not financially assist the buyer that is likely to have greater financial resources available.)

The final issue is financial assistance of any other type which materially reduces the company's net assets. Attention in this area has focused on the definition of 'net assets' and what constitutes the threshold of materiality for these purposes. Prevailing opinion is that net assets should be assessed as the market value of the target's total net assets including goodwill, calculated by reference to the offer price (in effect the target's actual net assets as opposed to their book value as shown in the accounts). There is some divergence of views as to what is 'material' for these purposes. Currently the safe view is taken to mean anything up to 1 per cent of the market value of the target's net assets, with many fees falling in the 0.5 to 0.75 per cent range. (Since break fees have been payable on some extremely large transactions there is also thought to be a risk that a particularly large sum could be deemed by the courts to result in a 'material' reduction, even though in fact it amounts to less than 1 per cent of the target's net assets. Although the point is untested, this means that regard may need to be given to the absolute figure agreed.)

Takeover Code

The Takeover Code applies where the target company is a UK plc. The Takeover Panel, which oversees regulation of takeovers in the UK, will act to ensure that the target's shareholders are not adversely affected by break fee arrangements, since these will necessarily reduce offeree shareholders' funds. There is also a concern that, where the target's board has received an approach from another party, a bona fide offer may be frustrated by the arrangements. The panel has introduced two safeguards:

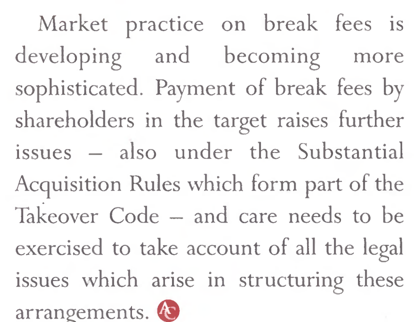
- a requirement that any break fee be 'de minimis', which will normally mean no more than 1 per cent of the offer value – an amount similar to the figure for judging the 'materiality' of any reduction in net assets for financial assistance purposes mentioned above; and
- confirmation by the target's board and that of its financial advisers that they believe the fee to be in the best interests of shareholders. This takes the form of a private comfort letter from the financial adviser describing the background to the negotiations leading to the agreement to pay the inducement fee and explaining why it is thought appropriate to pay a fee if there is a potential competing offer. It will also contain an opinion on behalf of the financial adviser, and board to the effect that the fee is fair and reasonable and in shareholders' best interests.

Contract

Another point which may need to be considered is whether particular break fee arrangements constitute a penalty and are therefore unenforceable. (This is the case where a sum is payable on breach of contract and exceeds a genuine pre-estimate of loss which the innocent party would be likely to suffer as a result of breach by the other party.) The point is not often an issue in the case of break fees, because payment of the fee is made under an agreement and on the happening of certain defined events, rather than as a result of breach of contract, but may be relevant in the context of breach of an exclusivity agreement.

Conclusion

Market practice on break fees is developing and becoming more sophisticated. Payment of break fees by shareholders in the target raises further issues – also under the Substantial Acquisition Rules which form part of the Takeover Code – and care needs to be exercised to take account of all the legal issues which arise in structuring these arrangements.



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