Reverse Break Fees: From Private Equity To Mainstream

Law360, New York (May 21, 2010) -- In last month’s column we discussed go-shop provisions and how that mechanism, once found exclusively in private equity deals, has now made its way into strategic buyer transactions. This month we focus on another significant deal term which has similarly migrated from private equity transactions to strategic transactions: reverse break fees.

A short history is in order. Way back in the Pleistocene era (the ‘90s), when a company was sold to a private equity bidder, the standard provision in the agreement provided that the private equity sponsor agreed simply to try to get the required financing; but that if it failed, the deal would be terminated with no financial consequences to the bidder.

This meant that the disappointed seller was left with nothing, other than deal expenses and a “damaged goods” asset. Private equity firms argued that “we complete all of our deals — if we failed to do so, our reputation would be shattered.”

That framework changed with the new millennium, as buyers were able to insist that financial buyers agree to “reverse break fees.”

Reverse break fees, initially limited to about 3 percent (higher where the seller had leverage) of the purchase price, payable to the seller if the buyout firm either failed to get the financing or determined not to proceed. A seller might be left with “damaged goods,” but at least it received a fee.

At the height of the private equity boom, some sellers were also able to get private equity buyers to agree to specific performance provisions which gave the seller the ability to enforce the private equity shop’s equity commitment letters and pursue the banks in the event they did not fund the deal.

Then came the 2008 dislocations in the equity and debt markets. Private equity buyers were tested, with several private equity firms moving forward and fulfilling their obligations even as their return on investment was clearly being materially impacted.

Some private equity firms either took advantage of the clear contractual language that had been drafted to allow them to pay the fee and terminate their deals, while other firms developed elaborate arguments to extract purchase price reductions.

Fast forward to 2009. The recent significant private equity transactions (IMS Health, IDC, Skype) suggest that reverse break fees are here to stay, but probably at significantly higher percentages as a proportion of the transaction value.
In some cases the reverse break fees serve as a cap on damages limiting the exposure of buyers and their financing banks. These provisions are clear that the obligations of the buyer will terminate upon payment of the reverse break fee.

Generally, prior to the credit crunch, strategic buyers paid little attention to the financing provisions in acquisition agreements, even when required to finance significant amounts in order to be able to close.

Strategic buyers often took the risk that credit and equity markets would not simply evaporate, leaving them on the hook to pay the agreed consideration, notwithstanding the impact of vastly higher interest rates lenders of last resort would charge, or, in the extreme, the complete absence of the necessary funding.

From a strategic transaction standpoint, the two gamechanging transactions were the Mars deal for Wrigley and Dow’s acquisition of Rohm and Haas. In Mars/Wrigley, Mars carefully thought through the risks and insisted on the inclusion of a provision effectively allowing it to pay a fee and walk from the deal at any time.

Dow did not agree to a break fee and thus ensued the courtroom drama surrounding Dow’s attempt to terminate its deal to acquire Rohm and Haas.

The full impact of not having a financing out or reverse termination fee became crystal clear as Dow was left without a contractual argument for nonperformance and had to argue that the agreement should not be enforced because if Dow were forced to do so, it would have significant adverse consequences for the company. Ultimately, Dow closed the deal and acquired Rohm and Haas.

Since then, in deals that require significant debt or equity capital raises, strategic buyers have become more attuned to the risks that changes in the capital markets can mean for their ability to finance their deal.

Obviously, sellers are never inclined to entertain a reverse break fee discussion, particularly where one or more bidders does not need external financing to complete the deal.

The negotiations of a reverse break fee are never simple and often quite complex. Should the buyer have complete discretion to pay the reverse break fee and walk away?

Can you limit the buyer’s ability to walk away to circumstances where it can’t obtain the financing because it loses its investment credit rating? Or is the investment credit rating tied to the issuance of additional equity between signing and closing?

Will the buyer retain complete discretion as to the conditions upon which it is willing to raise the equity funding so that it can prevent the transaction from becoming dilutive?

As the complexity increases, the greater the temptation becomes to deal with it by making sure that the reverse break fee is so large as to insure that the prospective buyer will feel pain before simply paying it and walking away.

We suspect that reverse break fees will be seen in more strategic deals as buyers remember the illiquidity of the last few years. Another interesting aspect of the increasing focus on reverse break fees in strategic deals is whether the concept of being able to pay and walk away, essentially an expensive option, will also be used to address deal uncertainty created by antitrust and other regulatory conditions.

In any event, reverse break fee appear to be here to stay and may give new meaning to the old phrase “to pay the piper.”
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