Breaking Up Is Harder To Do: The evolution of the reverse breakup fee puts the onus on the buyers to see deals through.

Source: Investment Dealers' Digest
Publication Date: 12-FEB-07

A recent twist on the breakup fee, creatively called reverse breakup fees, is starting to catch fire in deal making. Reverse breakup fees force acquirers to pay a penalty should a deal fail to close, as opposed to penalizing the target company.

These clauses are appearing more frequently in many large buyouts deals, and the penalties are climbing as a percentage of a deal's total value. If ever there were a sign of where power lies, it's clear that sellers are in the driver's seat.

As a percentage of a deal's value, reverse breakup fees have climbed to 3.49% in 2006, versus 2.77% in 2005. The numbers have undoubtedly been skewed by an outlier, a 25% reverse breakup fee in Tremisis Energy's tiny, $30 million acquisition of Ram Energy. But lawyers point out that there is no legal limit on such fees.

Standard breakup fees, in contrast, have been fairly flat at around 3.3%, although lawyers say they are trending up to the 4% range. The reason, they say, is that a Delaware judge upheld a 3.75% breakup fee in the Toys R Us acquisition last year, which signaled a safe range to the market. The court did not say how much is too much, but ruled that in this case, the breakup fee was not so high as to prevent another bidder from swooping in. Reverse breakup fees, meanwhile, have not been challenged in court and are becoming more common in M&A deals.

"The reverse breakup fee is really a response to the idea that buyout sponsors may not have all their financing in place when the deal closes," says James Abbot, an M&A attorney at Seward & Kissel in Manhattan. "Most major sponsors have financing readily available, but in a competitive bid situation, a selling company may have the bargaining power to put that to the test by insisting on a reverse breakup fee."

Not every company can get the clause included in the agreement, Abbott adds. "You don't want to overstate the prevalence of reverse fees, which will only occur in a particular bargaining posture and are heavily resisted by sponsors as being unusual and unnecessary."

The prevalence of these fees is connected to the availability of capital, lawyers say. Had debt been less plentiful and harder to come by, buyout shops may have not agreed to apply these clauses. For now, however, with attractive targets having a lot of bargaining power, these fees are here to stay. "I would expect to see a continued increase in the use of reverse breakup fees," says Robert Townsend, partner and head of the global corporate group of Morrison & Foerster.

The track record is solid in large buyouts. According to research by law firm Weil Gotshal, 100% of deals larger than $5 billion had such clauses last year. Even back in October 2005, the Neiman Marcus Group got such a clause inserted into its buyout contract with Warburg Pincus and Texas Pacific Group. Had the buyers not come through with financing, Neiman would have collected $140 million.

Strategic deals also are increasingly using such tactics. Guidant and Boston Scientific incorporated such a clause in their merger contract, which, combined with the standard breakup fee, would have totaled $800 million if the $25 billion merger fell apart.

But the buyout market is considered the birthplace of reverse breakup clauses. They have taken hold in the past year and a half, to a large degree in response to the onslaught of large consortium deals. The first notable case was the buyout of SunGard in September 2005. SunGard insisted on including a clause that would have paid the company $300 million had the deal been terminated.

(c) 2007 Investment Dealers' Digest Magazine and SourceMedia, Inc. All Rights Reserved.

http://www.iddmagazine.com http://www.sourcemedia.com