Breaking Up Is Costlier to Do.(fees for reverse buyouts)

Source: Mergers & Acquisitions: The Dealmaker's Journal
Publication Date: 01-APR-07

A recent twist on the breakup fee - creatively named a reverse breakup fee - is starting to catch fire in dealmaking. Reverse breakup fees, which are penalties paid by buyers that do not consummate a deal, are appearing more frequently in many club deals, and the amount of the fee - a percentage of the deal's value - is rising.

Reverse breakup fees have climbed to 3.49% in 2006, versus 2.77% in 2005. The numbers undoubtedly are skewed by the whopping 25% reverse breakup fee in Tremisis Energy Acquisition's $30 million acquisition of RAM Energy, which was completed in 2006. Deal lawyers, however, 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 inching 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 that case, the breakup fee was not so high as to prevent another bidder from competing. 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, deal attorneys say. Had debt been less plentiful, buyout shops may have not agreed to apply these clauses. For now, however, with attractive targets holding much of the bargaining power, the fees are here to stay. "I would expect to see a continued increase in the use of reverse breakup fees," says Robert Townsend, a Partner and head of the global corporate group at Morrison & Foerster.

The track record is solid in large buyouts. According to research conducted by Weil Gotshal, all deals that carried a price tag of $5 billion or higher last year had such clauses in the deal agreements. Even back in October 2005, Neiman Marcus Group got such a clause inserted into its buyout agreement with Warburg Pincus and Texas Pacific Group. Had the buyers not come through with financing, Neiman Marcus would have collected $140 million.

Strategic deals also are increasingly using such tactics. Guidant and Boston Scientific entered into "mutual termination agreements" totaling $800 million.

The buyout market, however, is considered the birthplace of reverse breakup fees. They have shown up in deal agreements in the past 18 months, to a large degree in response to the onslaught of big club deals. Before, it was extremely rare for those private equity firms to take on financing risks.

The first notable case was the $11.4 billion SunGard Data Systems buyout by a private equity consortium in late 2005. SunGard insisted on including a reverse termination fee in the deal agreement that would have allowed the seller to collect a penalty of $300 million if the deal had been terminated.