Paying to Break Up: The Metamorphosis of Reverse Termination Fees

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PAYING TO BREAK UP: THE METAMORPHOSIS OF REVERSE TERMINATION FEES

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Abstract

Despite our giving lip service to the binding nature of contracts, every law student learns that there are numerous possible “outs” or “walk away rights” associated with any contract. This Article examines one particular walk away right – the reverse termination fee (RTF) – in one particular category of acquisition transactions – strategic transactions.

In sophisticated acquisitions involving public companies, the risk that one party may walk away from the transaction is particularly high because there is generally an interim period between the signing of the agreement and the completion of the acquisition. Accordingly, acquisition agreements are peppered with various provisions designed to mitigate, allocate or otherwise address this deal risk. Allocation of deal risk is a vital component of deals where millions, if not billions, of dollars are at stake for buyers and sellers, as well as their shareholders and stakeholders.

One of the primary ways of dealing with the risk that one party may abandon the transaction is through termination fee provisions. Typically, public company acquisition agreements provide for the seller to pay the buyer a standard termination fee in the event that the seller does not complete the transaction due to specific triggers, commonly involving situations where a

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third-party bidder emerges for the seller. In an increasing number of transactions, acquisition agreements provide for what is often referred to as a reverse termination fee, i.e., a payment from the buyer to the seller in the event the buyer cannot or does not complete the acquisition as specified in the agreement.

While for several years there have been anecdotal reports of an increasing use of RTFs, this Article’s empirical study confirms that belief and examines why – despite repeated calls about the problematic nature of RTFs – such provisions are on the rise. Scholars and practitioners have analyzed standard termination fees in numerous articles, RTFs, on the other hand, have received minimal attention despite their growing popularity. An analysis of RTF provisions is particularly timely. In part due to the current financial crisis, such fees and their role as an exclusive remedy in acquisition agreements have been at the center of debate among parties in broken deals and the subject of heated litigation in the Delaware courts.

This Article presents the first detailed study in legal literature of the use of RTFs to allocate deal risk in strategic transactions. This Article uses original data collected from an empirical study of strategic acquisition agreements involving public companies in the United States announced during two separate periods, January 1, 2003 through December 31, 2004, and January 1, 2008 through June 30, 2009. The analysis undertaken in this Article reveals three important findings about RTFs. First, parties to acquisition agreements are increasingly using RTF provisions. Second, there is a shift in the contractual triggers that give rise to RTFs. This shift has given buyers greater flexibility to walk away from transactions. And third, this shift may prove problematic for sellers and buyers.
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INTRODUCTION

Despite our giving lip service to the binding nature of contracts, every law student learns that there are numerous possible “outs” or “walk away rights” associated with any contract. This Article examines one particular walk away right – the reverse termination fee – in one particular category of acquisition transactions – strategic transactions. Strategic acquisition transactions are deals where the buyer and seller are both operating companies and agree to the transaction in order to achieve operating synergies, market power or empire building.¹

Acquisition agreements are peppered with various provisions designed to mitigate, allocate or address the ramifications of deal risk.² The potential for deal risk is particularly pronounced in acquisition transactions involving public companies, which generally entail a significant interim period between the date of the signing of the acquisition agreement by the parties and the date of the completion of the transaction.³ Allocation of deal risk is a vital component of such deals where millions, if not billions, of dollars are at stake for buyers and sellers, as well as their shareholders and stakeholders.

Perhaps the most obvious deal risk is the risk of one party abandoning the transaction. One of the primary ways of dealing with this risk is through termination fee provisions. Typically, public company acquisition agreements provide for a standard termination fee (STF) to be paid

¹ See infra note 16-25 and accompanying text.
² Deal risk includes all the factors that could prevent or delay the closing of an announced acquisition transaction. For an overview of deal risks in business combinations, see Robert T. Miller, The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements, 50 WM. & MARY L. REV. 2007, 2015-2034 (2009).
³ See Lou R. Kling et al., Summary of Acquisition Agreements, 51 U. MIAMI L. REV. 779 (1997) (explaining corporate and regulatory reasons for delay between signing and closing, including stockholder approval by Seller's and/or Buyer's shareholders, antitrust filings under Hart-Scott-Rodino Antitrust Improvements Act of 1976 or other needed regulatory approvals, and time needed to line up financing, if necessary). Various corporate and regulatory requirements may mean that acquisition transactions can take months to complete. See, THERESE H. MAYNARD, MERGERS AND ACQUISITIONS 415 (2nd Ed. 2009). In transaction with a significant regulatory component, the time between signing and closing can take over six months. See Miller, supra note 2, at 2029.
by the seller to the buyer in the event that the seller does not complete the transaction due to specific triggers. These triggers commonly involve situations where a third-party bidder emerges for the seller. In an increasing number of transactions, acquisition agreements provide for what is often referred to as a reverse termination fee (RTF), i.e., a payment from the buyer to the seller in the event the buyer cannot or does not complete the acquisition as specified in the agreement.

This Article makes three contributions to the existing literature on deal risk in acquisition transactions. First, this Article provides a coherent explanation of the differences between strategic and financial (private equity) transactions. In doing so, it illustrates how parties in each of these types of transactions traditionally allocated deal risk.

Second, this Article presents the first detailed study in legal literature of the use of RTFs to allocate deal risk in strategic transactions. This Article uses original data collected from an empirical study of strategic acquisition agreements involving public companies in the United States announced during two separate periods, January 1, 2003 through December 31, 2004, and January 1, 2008 through June 30, 2009 to reveal two important findings about RTFs: that parties to acquisition agreements are increasingly using RTF provisions; and that there is a shift in the

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5 RTF provisions are also referred to as a “reverse breakup fee,” “bidder termination fee,” and “acquiror termination fee” provision.

6 The term private equity as used in this Article refers to privately held partnerships, which acquire and “take private” publicly held companies, primarily using a leveraged financing structure. See Brian R. Cheffins and John Armour, The Eclipse of Private Equity, 33 DEL. J. CORP. L. 1, 9 (2008).
contractual triggers that give rise to RTFs which provides buyers greater flexibility to walk away from transactions.\(^7\)

Third, in analyzing the transformation of RTF provisions, this Article goes beyond the classic economic analysis of contracts\(^8\) to contribute to an understanding of the organizational perspective on contracts.\(^9\) It provides an explanation for this transformation that is informed by, but not limited to, the social and economic contexts in which these deals took place.\(^10\)

Scholars and practitioners have analyzed STFs in numerous articles.\(^11\) RTFs, on the other hand, have received minimal attention despite their growing popularity. An analysis of RTF provisions is particularly timely. In part due to the current financial crisis, the payment of such fees and their role as an exclusive remedy in acquisition agreements have recently been at the center of debate among parties in broken deals and the subject of heated litigation in the

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\(^7\) The empirical study excluded transactions announced during the January 1, 2005 to December 31, 2007 period. RTFs were seldom used in acquisition transactions overall prior to 2005, however they began to play a prominent role in hundreds of private equity acquisitions of public companies in the 2005-2007 period. See generally Steven Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 101 (2008). This study aims to assess the impact on strategic transactions from the changing allocation of deal risk in private equity transactions and the ultimate breakdown of many of these deals. See Part I for a description of the increasing use of the RTF structure in private equity acquisitions of public companies to permit the buyer to walk away from the transaction by paying the RTF.


\(^10\) Numerous contract law scholars have argued that understanding deals requires an understanding of the "institutional and social context in which the parties strike a deal." Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV 1581, 1589 (2006); see also Smith & King, supra note 9, at 7-10 (presenting overview of relational contract theory).

Delaware courts. In essence, “deals are breaking up and buyers (and their lenders) are invoking termination rights and contract conditions. . . . as the basis for walking away.”

The 2003-2004 study in Part I of this paper illustrates the infrequent use of RTF provisions in strategic transactions prior to the aggressive private equity deal-making era of 2005-2007. This study analyzed 532 acquisition agreements publicly filed as exhibits to a Current Report on Form 8-K in the EDGAR system of the Securities and Exchange Commission for transactions announced during the 2003-2004 period. The 2003-2004 study shows that only 90 of these strategic transactions, or approximately 16.9%, included an RTF. A contract by contract analysis demonstrates that parties generally used RTF provisions to allocate similar risks to those allocated by STFs, such as the risk that the transaction would fail to close due to a superior proposal for the buyer. These results indicate that parties in strategic transactions used RTFs in a limited manner to compensate the non-terminating party, i.e. the seller, for the expenses that it incurred during the transaction and to deter bidders for the buyer from obstructing the transaction. Furthermore, the vast majority of these contracts continued to include a right for the seller to seek the remedy of specific performance in lieu of the RTF.

While RTFs were of limited use in strategic deals in the 2003-2004 period, in the 2008-09 period, they emerged in numerous acquisition agreements between strategic sellers and buyers, in forms that differ significantly from their prior use. This Article’s study of 291 strategic acquisition agreements in deals announced between January 1, 2008 and June 30, 2009 found

13 See Appendix A for details of the methodology used to identify strategic transactions.
15 Specific performance is an extraordinary equitable remedy that compels a party to execute a contract according to the precise agreed terms or to execute it substantially so that under the circumstances, justice will be served. See infra notes 54 – 64 and accompanying text.
that 76 agreements, or approximately 26.1%, include an RTF, a significant increase from 16.9% of deals in 2003-2004. An analysis of each of these agreements demonstrates that parties are utilizing RTFs more frequently and to allocate different types of deal risks, such as the risk that the buyer would be unable to obtain financing for the transaction or that the buyer would refuse to close the transaction for any reason. Furthermore, RTFs are increasingly being used as the seller’s sole and exclusive remedy in the event of the buyer’s failure to close the transaction. That is, in this recent era of deal-making, sellers are often contractually barred from seeking specific performance against the buyer and face a greater risk that the transaction will not be completed.

These recent acquisition agreements appear to have adopted termination structures substantially similar to those used in the private equity boom of 2005-2007. While the private equity structure ultimately proved problematic for sellers, it may have paved a way for innovations and learning in the strategic deals of 2008-mid 2009. The migration of private equity style RTF provisions to strategic deals and the rising use of such provisions indicate that there is much to discuss about the nature of these provisions.

Understanding the use of RTFs is important for a number of reasons. First, the differing use of the RTF provision presents important models for structuring deal risks. Second, exploring the evolution of this provision can give us greater insights about how parties use complex contractual provisions not only to shift the allocation of risk, but also to engage in contractual innovation. Third, recent troubles in strategic transactions using RTF provisions reveal the somewhat problematic nature of these provisions. Fourth, the varied uses of RTF provisions have important implications for the ways in which such fees are assessed by courts.
With these considerations in mind, this Article proceeds in four parts. Part I provides an overview of the structure of acquisition transactions and the contractual remedies generally set forth in acquisition agreements. Part I also details the traditional differences between the structure of strategic and private equity acquisitions.

Part II describes the results of the empirical study undertaken in this Article. This Article’s empirical study of strategic deals announced between January 1, 2003 and December 31, 2004 demonstrates the traditional use of RTF provisions. Part II then provides the results of the empirical study of strategic deals announced between January 1, 2008 and June 30, 2009, along with a comparison of this data with the results from the 2003-2004 period.

Part III examines the increasing use of RTFs in the 2008 to mid-2009 period and the migration of the RTF provision from private equity transactions to strategic transactions in the wake of the financial crisis. Part III analyzes the reasons why strategic buyers have eagerly embraced these provisions and the competing rationales of sellers that have agreed to such provisions. Part III argues that there are a number of shortcomings in the RTF structures being used. Part IV concludes. The technical details and methodology of the empirical study are included in Appendix A.

I. THE STRUCTURES OF ACQUISITION TRANSACTIONS

Before discussing the transformation of RTF provisions in acquisition agreements, a basic overview of acquisition transactions and agreements is helpful.16 Section A below begins by explaining the differences between the two most oft-discussed acquisition types, strategic transactions and financial transactions, which are generally undertaken by private equity buyers. Section B then sets forth an overview of the structure of acquisition agreements. It explains the

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16 See Kling et al., supra note 3, for a detailed overview of the various provisions included in acquisition agreements.
origins and traditionally limited use of RTF provisions in strategic transactions. Section C then examines the significant differences in acquisition agreements in transactions involving strategic buyers and those involving private equity buyers, and explains the rise of RTFs in private equity buyouts.

A. Strategic Buyers vs. Private Equity Buyers

As set forth in a leading book on mergers and acquisitions, “there are two basic types of buyers – strategic and financial.” The concept of a strategic buyer versus a financial buyer is frequently used in academic and industry literature, as well as in Delaware court opinions. Strategic transactions generally involve operating synergies between the businesses of the buyer and the seller or the aggregation of greater market power in a particular product line, for example the combination of two pharmaceutical companies. Strategic buyers are typically operating “companies that are already in the [seller] company’s industry or in a similar industry.” Unlike financial buyers, strategic buyers generally aim to buy companies whose assets they can use to supplement and/or complement their existing business. In terms of the acquisition consideration, strategic buyers can use cash, stock or a combination of the two; in fact a significant portion of strategic transactions involve the use of buyer stock as consideration. In addition, since

18 See, e.g., In re Lear Corp. S’holder Litig., 926 A.2d 94, 104 (Del. Ch. 2007) (stating that “a strategic buyer would seemingly have been presented with substantial freedom to develop a topping bid for [the seller] premised on a post-consummation business strategy that incorporated the greater synergies that arguably can be reaped in a cash conquest resulting in a combined asset base under the acquirer’s sole control”); In re Topps S’holder Litig., 926 A.2d 58, 62 (Del. Ch. 2007); WILLIAM J. CARNEY, Mergers and Acquisitions: The Essentials 111 (2009); MAYNARD, supra note 3, at 10, 63; Paul M. Healy et al., Which Takeovers Are Profitable? Strategic or Financial?, 38 SLOAN MGMT. REV. 45 (Summer 1997); Christina Sautter, Shopping During Extended Store Hours: From No Shops to Go-Shops – the Development, Effectiveness, and Implications of Go-Shop Provisions in Change of Control Transactions, 73 BROOK. L. REV. 525, 555 (2008).
19 See CARNEY, supra note 18, at 111; REED ET AL., supra note 17, at 2; STEPHEN M. BAINBRIDGE, Mergers and Acquisitions 41-42(2d ed. 2009).
20 MAYNARD, supra note 3, at 11.
strategic buyers can generate revenues from functioning businesses or sell stock to interested investors, they can often generate their own cash to fund acquisitions.

Financial transactions emerged in the 1980s which witnessed the heyday of corporate raiders and junk bonds, and the formation of private equity powerhouses such as Kohlberg Kravis Roberts & Co. (KKR).\textsuperscript{22} Financial buyers, such as private equity firms, differ from strategic buyers in both the goals of the transaction and the structure of their acquisition transactions. Private equity buyers seek to acquire companies that they can grow and/or improve.\textsuperscript{23} The ultimate goal of such buyers tends to be to "sell the cleaned up company to another buyer within a few years for a substantial gain, or alternatively, to take the company public."\textsuperscript{24} In addition, unlike strategic transactions where the merger consideration consists of cash or stock, private equity buyers generally tend to acquire companies through the use of leverage, which includes debt financing commitments from a consortium of lenders. "A private equity sponsor needs the assets of the target company as collateral to borrow the funds necessary to acquire the company. Therefore, private equity investors seek target companies that can generate sufficient cash to service the debt that is incurred to acquire them."\textsuperscript{25} As discussed in Part I.C, the use of leverage necessitated certain contractual terms in private equity acquisition agreements.

In part to reflect the differing goals of strategic buyers versus private equity buyers, and in part to reflect the differing structure used to achieve the transactions, acquisition agreements in strategic transactions have traditionally reflected marked differences from those governing private equity transactions. The discussion below begins with a brief description of acquisition

\textsuperscript{22} For a brief overview of the emergence of financial transactions, see MAYNARD, supra note 3, at 516-519.
\textsuperscript{23} See MAYNARD, supra note 3, at 10.
\textsuperscript{24} See MAYNARD, supra note 3, at 63.
agreements, and follows with an overview of the traditional differences in acquisition agreements involving strategic versus private equity buyers.

B. The Traditional Structure of Acquisition Agreements

1. Representations, Covenants, & Closing Conditions

Most acquisition agreements, whether involving strategic buyers or private equity buyers, follow a similar structure with several key parts, including representations and warranties, covenants, closing conditions and termination rights, which make up the bulk of the agreement.\(^{26}\) These parts work together and interrelate with each other so that parties are in essence designing a package of rights and obligations. The complex relationship among these provisions is in part necessitated because of the “often long period between execution of the acquisition agreement and the closing, caused by the need for multiple approvals from third parties, government authorities, and shareholders…”\(^{27}\)

The intersection of these various provisions can be difficult to understand and the terms vague.\(^{28}\) For example, an interpretation of the extent to which a failure of certain closing conditions may result in termination rights involves judgments about the interplay of these terms. Moreover, assessing the extent to which parties are allocating risk by the use of certain closing and termination rights depends on a careful reading and interpretation of the intricacies of the contractual language.\(^{29}\)

a. Representations and Warranties

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26 See Maynard, supra note 3, at 307-313.
27 Carney, supra note 18, at 109.
29 See Hill, supra note 28, at 200.
The representations and warranties serve as both a “disclosure tool” and as a “risk allocation tool.” 30 For the buyer, not only do the “seller’s representations assist the buyer in understanding the business it is acquiring and in doing its due diligence,” but they also “allow the buyer to refuse to close the transaction if the representations are not true at closing,” generally subject to a materiality or material adverse effect qualification. 31 For the seller, the buyer’s representations and warranties allow the seller “to know who it is dealing with, to understand exactly what has to happen before the buyer can close the deal and to be as sure as possible that on the day of closing the buyer can actually come up with the purchase price.” 32

b. Covenants

The covenants section of the agreement addresses the period between signing and closing and includes a forward looking set of provisions, which obligate both the buyer and seller “to take, or refrain from taking, certain actions.” 33 Most acquisition agreements include covenants that govern the transaction process, such as a covenant from the seller to take certain actions to obtain any necessary stockholder approvals. Buyers generally insist on a covenant from the seller that it will operate its business only in the “ordinary course” and “consistent with past practice” between signing the acquisition agreement and closing in order to ensure that no significant or unusual transactions are undertaken without buyer’s knowledge and consent. 34 Some of the most negotiated covenants in acquisition agreements are related to the buyer’s covenants regarding the acquisition consideration, for example covenants related to obtaining

30 Maynard, supra note 3, at 309-10. In general this “bring-down” of the representation and warranties to the time of closing is subject to a material adverse effect, in order to exclude minor inaccuracies from serving as a failure of closing conditions. See Kling et al., supra note 3, at 800; Choi & Triantis, supra note 12, at 13-14.
31 Kling et al., supra note 3, at 783; Miller, supra note 2, at 2044.
32 Kling et al., supra note 3, at 794.
33 Kling et al. supra note 3, at 782.
34 See Carney, supra note 18, at 106.
financing. Certain other highly negotiated covenants relate to deal protection. These are discussed in Part I.B.2 below.

c. Closing Condition

The conditions section sets forth the obligations that must be satisfied by the parties at or before the closing of the transaction. Thus, closing conditions “give rise to what M&A lawyers customarily refer to as walk-away rights.” In addition to closing conditions related to the continuing veracity of the representations and warranties, the closing obligation includes a condition that “the other party shall have performed and complied with its covenants and agreements between signing and closing.” For example, an acquisition agreement may contain as a “condition to [the buyer’s] obligation to close on the acquisition and pay the purchase price” the delivery by the seller “of certain written assurances from [the seller’s] auditors. If [the seller] cannot satisfy this condition at (or before) the date set for closing, then the buyer can walk away from the deal without any recourse on the part of [the seller].” Other closing conditions relate to exogenous circumstances deemed necessary to close the transaction, such as availability of financing, governmental and other third-party consents, or shareholder approval.

Both parties to acquisition agreements spend a considerable amount of time addressing the closing conditions and related provisions in part to balance the seller’s desire for certainty and the buyer’s desire to maintain flexibility until closing. Sellers, in particular public companies subject to the demands of shareholders, place a great deal of emphasis on certainty of closing. This emphasis is due to risks that the seller could face with respect to loss of employees and

35 MAYNARD, supra note 3, at 323; See Choi & Triantis, supra note 12, at 12 (describing closing conditions as “contingencies under which the parties are free to walk away from a deal.”).
36 Kling et al., supra note 3, at 782.
37 MAYNARD, supra note 3, at 323
38 See Brian JM Quinn, Bulletproof: Mandatory Rules for Deal Protection, 32 The Journal of Corporation Law 865, 882-82 (setting forth reasons why sellers want to ensure that a signed transaction becomes completed).
senior management as a result of announcement of the transaction, the prolonged disruption of ordinary business operations in connection with the proposed sale of the company, and the fear of securities class action lawsuits in the event that a transaction fails to close. Furthermore, the breakdown of a publicly announced acquisition will likely mean that “the rejected [seller] will suffer valuation backlash [and] ... is going to be viewed by the market as tainted, and that taint is going to be directly reflected in the target’s stock price.”

Buyers, on the other hand, want to maintain maximum flexibility to avoid closing the transaction, i.e. optionality, in the event of some change in expected circumstances.

d. Termination Rights

In order to balance the inevitable tensions in the goals of sellers and buyers, acquisition contracts provide for termination rights. These termination rights are typically derived from the closing conditions set forth in the agreement and can be exercised in the event that specified conditions to closing are not satisfied or waived. For example, termination rights arise if the transaction is not completed by a specified date or “if a final, non-appealable injunction against the transaction is obtained or if the conditions otherwise become impossible to satisfy.”

Parties often spend considerable time negotiating two specific termination rights: (i) terminations in the event of a material adverse event or change (MAC) with respect to the seller

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40 See Choi & Triantis, supra note 12, at 9 (stating “In light of the foregoing objectives of contracting and the tension between the needs for commitment and flexibility, an important feature of modern contracts is the right of one party or another to walk away from the contract: to terminate, cancel or be excused from its obligations. Practitioners sometimes refer to this as the characteristic of optionality.”).
41 See Choi & Triantis, supra note 12, at 12 (noting, “Contracting parties do not choose between conditions and termination rights, but rather design a package of these terms.”).
42 Kling et al., supra note 3, at 808.
(and sometimes the buyer) in the interim period between signing and closing; and (ii) terminations related to the emergence of a third-party bidder. The sections below discuss these provisions in more detail.

2. Deal Protection

Parties to acquisition transactions generally include certain “deal protection” devices, such as STFs, in order to provide “protections from, or compensation for, interference with the transaction by a third party.” These deal protection devices are woven into the covenants, conditions and termination sections of the acquisition agreements. Deal protection devices have long been blessed by the Delaware courts, particularly in transactions not involving a sale of control, as “permissible means of protecting a strategic merger from third-party interference.”

13 THE M&A LAWYER (January 2009) (finding that 98% of the deals studied contained a MAC walk right). Typically a MAC is defined as “any change, event, violation, inaccuracy, circumstance or effect that is materially adverse to the business, assets, liabilities, financial condition, results of operations or prospects of the Target and its Subsidiaries taken as a whole, other than as a result of: (i) changes adversely affecting the United States economy (so long as the Target is not disproportionately affected thereby); (ii) changes adversely affecting the industry in which the Target operates (so long as the Target is not disproportionately affected thereby); (iii) the announcement or pendency of the transactions contemplated by this Agreement; (iv) the failure to meet analyst projections, in and of itself; (v) changes in laws; (vi) changes in accounting principles; or (vii) acts of war or terrorism.” Id. at 19. Of course, the carve-outs set forth in this definition differ based on the industry and circumstances of the parties to the transaction. For a comprehensive study of MAC provisions, see Miller, supra note 2. See also Ronald J. Gilson & Alan Schwartz, Understanding MACs: Moral Hazard in Acquisitions, 21 J.L. & ECON. & ORG. 330, 330-31 n.3 (2005).

44 While the parties generally spend considerable time negotiating the definition of a MAC, courts have interpreted this provision very narrowly. In a recent decision, Hexion Specialty Chemicals et al. v. Huntsman Corp. (Del. Ch. C.A. No. 3841-VCL)(Sept. 29, 2008), the Delaware Chancery Court reiterated that the Delaware courts take a long term view with respect to determining whether a MAC has occurred and have in fact never found a MAC to have occurred in the context of an acquisition transactions. (“The important consideration . . . is whether there has been an adverse change in the target’s business that is consequential to the company’s long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than month . . . Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence.”); see also Frontier Oil v. Holly Corp., 2005 WL 1039027 at *34 (Del. Ch. Apr. 29, 2005); In re IBP, Inc. S’holders Litig., 789 A.2d 14, 68 (Del. Ch. 2001) (stating, “Merger contracts are heavily negotiated and cover a large number of specific risks explicitly. As a result, even where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror.” (footnote omitted)).

45 Mirvis, supra note 21, at 159.

46 See id. In transactions not involving a change of control, the Delaware courts have reviewed deal protection devices under the two-step Unocal enhanced scrutiny standard. See Omnicare, Inc. v. NCS Healthcare, Inc., 818
Generally, in acquiring a public company, the buyer seeks “to minimize the likelihood of a third-party bidder emerging after signing.” In most negotiations, lawyers spend considerable time drafting and discussing covenants that address to what extent one of the parties, most often the seller, can negotiate with a third-party bidder that emerges after signing of the original acquisition agreement. While more recently, in order to alleviate fiduciary duty concerns, some buyers, generally private equity firms, have provided for a brief “go-shop” period, most buyers will insist on a “no-shop” covenant which prohibits “the seller from soliciting or encouraging a transaction with another bidder.” It is common for the seller to obtain a “fiduciary out” exception to the no-shop provision “that will allow negotiation with, and the furnishing of information to, a third-party bidder if the seller’s . . . board of directors fiduciary duties require them to do so.”

The emergence of a third-party bidder can also lead to termination rights under acquisition agreement. “The key issue is often whether the [seller] can terminate the agreement in order to accept a competing proposal . . . [or] whether the mere emergence of a third party bid . . . should give the buyer a termination right even if the [seller] wishes to stick with it.” In addition, to further protect the deal, buyers generally insist on an STF to be paid by the seller to the buyer in

A.2d 914 (Del. 2003). Under the first step of the Unocal enhanced judicial scrutiny of deal protection measures designed to protect a corporation's merger agreement, the seller’s board of directors must demonstrate they had reasonable grounds for believing that a third-party bid would be a danger to corporate policy and effectiveness. Omincare, 818 A.2d at 935. The second step requires that the directors “demonstrate that their defensive response was reasonable in relation to the threat posed” meaning that such deal protection devices were not “coercive” or “preclusive,” and were within a “range of reasonable responses” to the perceived threat. Id. Deal protection devices in change-of-control transactions involves the more exacting Revlon test which requires that the device is designed to secure the best value reasonably available to shareholders.

Kling et al., supra note 3, at 799.

A “go-shop” is a provision that provides for a period of time after the signing of the transaction during which the seller can actively solicit third-party bidders. For a detailed discussion of go-shops, see Sautter, supra note 18.

Kling et al., supra note 3, at 799; see also Keith A. Flaum, 2007 M&A Deal Point Study: Public Targets, 12 THE M&A LAWYER (February 2008) (finding that no strategic transaction in 212 deals studied included go-shop provisions).

Kling et al., supra note 3, at 799.

Kling et al, supra note 3, at 808.
the event the acquisition agreement is terminated prior to closing due to a competing proposal for the seller. The section below addresses in more detail the role of and limitations on such fees.

3. Termination Fees and Equitable Remedies

As discussed above, acquisition agreements generally include a termination section that sets forth the circumstances under which the parties can terminate the agreement. In connection with the termination provisions, acquisition agreements also include certain sections to address remedies for a breach or termination of the agreement by either party. Traditionally, the vast majority of acquisition agreements have included a specific performance remedy for both the buyer and seller, subject to payment of termination fees as an alternative remedy under certain circumstances.\(^{52}\) While specific performance has played a significant role in strategic acquisition agreements, as demonstrated by the empirical study in Part II, the availability of specific performance has been limited in strategic deals in the 2008 to mid-2009 period. Instead, the RTF has begun to replace specific performance in a number of transactions. In Part III, I explore why that is the case. Before turning to the recent limitations on specific performance in strategic deals, it is worth discussing the availability of specific performance in strategic merger transactions.

a. Specific Performance

Specific performance is an extraordinary equitable remedy that compels a party to execute a contract according to the precise agreed terms or to execute it substantially so that under the circumstances, justice will be served. The goals of specific performance are to ensure the promisee receives the full benefits of his bargaining efforts and to deter opportunistic promisors

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\(^{52}\) See Griffin, *supra* note 43, at 11 (finding in 2008 study of strategic acquisitions that 93% included specific performance remedy, of which almost all granted that remedy to both buyer and seller).
from breaching the contract.53 “Historically specific performance has been viewed as an extraordinary remedy available only when a plaintiff lacked an adequate remedy at law or would otherwise suffer an irreparable injury.”54

While specific performance is not typically the preferred remedy of courts, courts have been known to grant specific performance in the merger context—in fact, “courts routinely award specific performance to enforce contracts to sell businesses . . .”.55 More frequently, the specific performance remedy is sought by and granted to a buyer that claims “it cannot be made whole unless it can specifically enforce the acquisition agreement, because the [seller] company is unique and will yield value of an unquantifiable nature, once combined with the acquiring company,” and that damages would not be an adequate remedy.56 Nevertheless, in a number of high profile cases, courts have granted specific performance to sellers as well, as most visibly demonstrated in the famous case of IBP v. Tyson and more recently demonstrated in the Genesco v. Finish Line litigation.57

The Delaware Chancery Court surprised many with its specific performance ruling in the contentious acquisition of IBP by Tyson. In this case, Tyson, the largest chicken producing company, attempted to invoke a MAC clause in order to exit its merger with IBP, the largest beef

55 Id.
56 See IBP, 789 A.2d at 82-83.
57 Sellers have also used the threat of a specific performance suit to force reluctant buyers to complete a transaction. For example, “In the case of the proposed Dow/Rohm and Haas merger, Dow claimed it didn’t have to close the merger, motivating Rohm & Haas to sue for specific performance. The agreement contained a normal termination fee, meaning that Dow couldn’t just pay to walk away. Furthermore, the tight material adverse effect (MAE) clause made it unlikely that Dow would have won its case. The dispute was ultimately settled and Dow bought Rohm at the previously agreed upon price plus a ticking fee . . .” M&A Optionality: Hell Hath No Fury Like a Target Scorned (June 16, 2009), http://www3.gsionline.com/LegalCurrents/Article_20090616_E1.asp?contactid=48255779999999. For more information on the Dow Chemical’s acquisition of Rohm & Hass, see Forcing M&A: Courts, Can Dow Walk from Rohm? (Feb. 5, 2009), http://www3.gsionline.com/legalcurrents/Article_20090205_E3.asp?contactid=C9MJ0A40000F.
In rejection Tyson’s MAC claim, the court explained that Tyson decided to purchase IBP “fully aware of the cyclical factors that affect commodity meat products.” Yet following a post-merger agreement cyclical downturn in the beef industry, Tyson attempted to invoke its MAC clause. The court explained that the “notion that the [MAC clause] gave Tyson a right to walk away simply because of a downturn [in the industry] is untenable.” The court viewed Tyson’s attempt to assign the external risk of the deal to IBP via the MAC as inappropriate. Instead of awarding typical money damages for breach, the Delaware Court ruled for specific performance of the merger agreement, explaining that specific performance was necessary due to the difficulty in calculating damages.

Similarly, in a 2007 dispute between shoe and hat retailer Genesco, Inc. and sportswear retailer Finish Line, Inc., the Tennessee chancery-court ruled that Finish Line must complete its $1.5 billion acquisition of Genesco. After intense criticism of the Finish Line’s handling of the details of the merger, the Tennessee Court concluded that the acquisition agreement did not permit Finish Line to refuse to close the transaction by claiming material adverse changes at Genesco. In ordering specific performance of the acquisition agreement, the court recognized that the announcement of a merger transaction and the ensuing litigation between the parties placed the seller “in a state of limbo. Uncertainty has negatively affected its stock price, vendor relationships, employee morale, public perception, and virtually every other aspect of its business.” Furthermore, the court stated that the acquisition agreement itself placed tremendous pressure on the ongoing operations of the seller during the pendency of the

58 See Listokin, supra note 53, at 3.
59 See IBP, 789 A.2d at 80-81.
60 See IBP, 789 A.2d at 137.
61 See Listokin, supra note 53, at 11.
62 See IBP, 789 A.2d at 184-190.
transaction: “Due to restrictions that the Merger Agreement imposes on its activities pending closing, it has been unable to open new stores, make significant capital expenditures, and otherwise engage in ordinary business activities that would be inconsistent with [the buyer’s] plan for [the target] but that would be necessary or desirable for an independent [target].”

Curiously, while the acquisition agreement provided for a specific performance remedy, the court ordered specific performance in reliance solely on Tennessee principles of equity rather than citing the provision in the actual agreement requiring it.

b. Termination Fees

(1) Standard Termination Fees

The vast majority of public company acquisition agreements include STF provisions. STFs are fees payable by the seller to the buyer in the event the seller terminates the agreement prior to closing, under certain circumstances. These circumstances generally encompass a failure to close the transaction because (i) the seller’s board terminates the agreement in order to accept a competing offer; (ii) the seller’s board changes its recommendation in favor of the transaction and the buyer elects to terminate the merger agreement rather than proceed with the shareholder vote; or (iii) the transaction fails for some other specified reason, such as being voted down by the seller’s shareholders, after a competing proposal has been announced and is agreed to or closed within a specified period of time (ranging from 6 to 18 months).

STFs serve a number of uses in the acquisition transaction. Obviously, an STF provision can ensure that the buyer “will receive a material consolation prize to defray the [buyer’s] investment – in time, out-of-pocket expense and opportunity cost – in the event the transaction is not

\[\text{\textsuperscript{64}} \text{Id.} \]

\[\text{\textsuperscript{65}} \text{See CARNEY, supra note 18, at 112.} \]

Most often, STF provisions are used as a deal protection device by the buyer in order to deter a third-party bidder and agreed to by sellers in order to “cement a deal with a favored [buyer] while keeping hostile [buyers] at bay.” In addition, STFs reflect a recognition by sophisticated parties that “leaving the outcome of a breach, including assessment of damages to a judge or even a jury, creates enormous uncertainty and a high degree of variance in expected outcomes which may be either outrageously high or low from the ex ante view of the parties.”

The size of STFs has been limited by fiduciary duty principles that require that directors maximize shareholder value in a change of control transaction and cannot enter into an agreement that deters a competing buyer or coerces the seller’s stockholders to accept the agreement. A study of termination fees in acquisition transactions announced during 2005 found that these fees ranged from 0.1–10.0 percent of deal value, with a median of 3.2 percent and a mean of 3.1 percent. The study found similar results for transactions announced in 2004 and 2003.

(2) Reverse Termination Fees

Far less common than STFs are RTFs, i.e. fees payable by the buyer to the seller. As recently as 2003, some experts deemed them to be an interesting and new method for parties to

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67 Houlihan Lokey, supra note 66, at 2.
69 CARNEY, supra note 18, at 113.
70 See In re Toys “R” Us, Inc. S’holder Litig, 811 A.2d 975, 999 (Del. Ch. 2005) (explaining that under Revlon and its progeny, once directors decide to sell corporation, they should do what any fiduciary should do when selling an asset, which is maximize sales price for benefit of those to whom their allegiance is pledged; in corporate context, that means that directors must seek highest value deal that can be secured for stockholders regardless of whether it is in best interests of other corporate constituencies.); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 923 (Del. 2003).
71 See Houlihan Lokey, supra note 66, at 4.
allocate deal risk in acquisition transactions. Perhaps reflecting in part their limited use, the scholarly literature analyzing RTFs has been limited.

RTF provisions arose in the late 1980s in the context of two competitor companies entering into an acquisition transaction. Because a combination of two competitors potentially involved regulatory risk or the risk of a third-party bidder for either the buyer or the seller, the acquisition agreement at times included buyer and seller provisions for termination fees in the event that such risks caused the deal to fail. The 2003-2004 empirical study in Part II of this Article describes in greater detail the typical uses of RTFs in strategic transactions.

Not only were RTF provisions used in a minority of acquisition transactions, but prior to the breakdown of deals with the onset of the 2007 financial crisis, the courts saw little litigation over these provisions. Prior to 2007, the two most prominent disputes over RTFs – Thomson’s proposed acquisition of LTV and Central and South West Corporation’s proposed acquisition of El Paso Electric – arose in cases involving companies in bankruptcy. Each case demonstrates

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72 Spencer Klein & Steven Epstein, Risky Business, DAILY DEAL, Jun. 30, 2003; see also Huntsman/Rexene Mired in Acrimony, 20 Mergers & Restructuring 47 (Dec. 9, 1996) (detailing failed bid by Huntsman Corp. to purchase Rexene Corp. when Rexene insisted on an RTF, the article noted that “a reverse break-up fee is virtually unheard of”).


74 See Bates & Lemmon, supra note 73, at 470 (finding that in 1989 less than 2% of all deals included seller termination fees and 1% included buyer termination fees while by 1998 termination fees were significantly more prevalent with over 60% of all deals including seller termination fees and 1% including buyer termination fees); see also Darren S. Tucker & Kevin Yingling, Keeping the Engagement Ring, 22 Antitrust 71, 72 (Summer 2008).

one of the traditional uses of the RTF provision – to allocate regulatory risk in acquisition transactions. The award of the RTF provisions in each of these cases, and the seller’s insistence on such provisions in their acquisition agreements, reveal the utility of such fees in allocating regulatory risk to the buyer and in providing compensation to the seller in the event that regulatory approval hindered completion of the transaction.76

The 1992 dispute over the RTF between Thomson-CSF, S.A. (“Thomson”), a defense electronics company that was primarily owned by the French government, and LTV Corporation is the quintessential example of the traditional use of RTFs. Prior to entering into the acquisition agreement, Thomson had engaged in a heated contest with Lockheed Corporation (“Lockheed”) and Martin Marietta Corporation (“Martin Marietta”) in order to acquire and operate the aircraft and missile business of LTV Corporation (“LTVAD”).77 A significant portion of LTVAD’s revenues were derived from U.S. military contracts.78 Despite the fact that Thomson offered a higher bid, LTVAD indicated that it preferred Lockheed and Martin Marietta’s offer.79 LTVAD’s primary concern with the Thomson acquisition was that it involved a significant risk

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76 A number of other high-profile strategic transactions have also involved reverse break up fees tied to specific regulatory or industry risk. For example, in the $500 million all-cash acquisition of ProBusiness Services Inc. by Automated Data Processing Inc., ProBusiness negotiated a $25 million RTF as a result of antitrust concern. The fee was payable if ProBusiness terminated the agreement “if any litigation or proceeding . . . has been threatened to be instituted by any Person or governmental body” that in the board’s good faith judgment is reasonably likely to enjoin or impair the benefits of the deal.” Agreement and Plan of Merger by and among Automatic Data Processing, Inc., ADP Merger Corp. and ProBusiness Services, Inc. (Form 8-K) § 7.1(c) (Jan. 5, 2003); See also, Agreement and Plan of Merger between Guidant Corporation, Diane Acquisition Corporation and Cook Group Incorporated (Form 8-K) §§ 6.2, 6.3 (July 30, 2002) (providing for $50 million fee to seller in event that agreement was validly terminated based on condition to closing that was contingent upon positive clinical trial results and resolution of patent suit in favor of target).


78 See Chateaugay Corp. at 850.

79 See id. at 852. See also Anthony Veloce, Jr., Thomson, Carlyle Face Challenges in Bid to Win LTV’s Aviation Business, 136 AVIATION WEEK & SPACE TECH. 23 (Apr. 13, 1992). In addition to the regulatory risk, LTV was also concerned that Thomson’s ownership of LTV’s missile business would substantially impair the company’s performance of contracts with the Pentagon. Id.
that the deal might be unable to obtain approval\textsuperscript{80} necessary under Exon-Florio legislation from the Committee on Foreign Investment in the United States (‘‘CFIUS’’).\textsuperscript{81} After numerous hearings before the bankruptcy court regarding concerns with Thomson’s bid and assurances from Thomson that the company would be able to insulate foreign ownership, control or influence through a Special Security Agreement, the court finally approved the sale of the divisions to Thomson. Significantly, in order to alleviate the concerns of LTVAD and the bankruptcy court, Thomson offered LTV a $20 million RTF, to cover LTV’s potential losses, payable in the event that Thomson “failed to close the transaction due to an inability to obtain the requisite security approvals from the U.S. government.”\textsuperscript{82}

After months of wrangling with the U.S. government to obtain clearance for the transaction and strident objections by members of Congress to Thomson’s planned acquisition, it became clear that Thomson would be unable to obtain CFIUS approval. Accordingly, Thomson informed LTV that “it considered the acquisition agreement terminated.”\textsuperscript{83} However, Thomson refused to pay the RTF, arguing that LTVAD had violated its covenant to use reasonable efforts to consummate the transaction by assisting Thomson in procuring necessary government


\textsuperscript{81} Approval of the President is required under the Exon-Florio Amendment to the Defense Production Act of 1950, Pub.L. No. 100-418, 102 Stat. 1107, 1425-26 (1988). The Exon-Florio Amendment authorizes the President “to suspend or prohibit any ... acquisition ... by or with a foreign person, of a person engaged in interstate commerce in the United States when, in the President's view, the foreign interest exercising control over that person might take action that threatens to impair the national security.” 31 C.F.R. § 800.101. The President has delegated authority for implementing Exon-Florio to CFIUS, which is comprised of representatives from the Departments of Treasury, State, Commerce, and Defense, as well as the Council of Economic Advisors, Office of Management and Budget, and the U.S. Trade Representative. Exec. Order No. 12,661, 3 C.F.R. 618-24 (1988). The Treasury Department has issued regulations that implement Exon-Florio by means of a voluntary filing system, pursuant to which the parties to a foreign acquisition notify CFIUS of a proposed transaction. See 31 C.F.R. § 800.101 et seq., § 800.402(b)(5) (1992).

\textsuperscript{82} See id. at 853. See also LTV v. Thomson-CSF (In re Chateaugay Corp.), 186 B.R. 561, 593 (Bankr. S.D.N.Y 1995) (stating, “the fee was a significant factor in the creditors' and the Court's decision to approve the sale to Thomson”).

clearance. After a seven-day trial before the bankruptcy court, the court ordered Thomson to pay a $29.3 million judgment to LTV to cover the RTF and expenses.

While historically of limited use in strategic acquisition transactions, RTFs began to take on a much more significant role in private equity acquisition agreements beginning in 2005. In order to understand the surge in the use of RTF provisions, one must first understand the principal ways in which private equity acquisition agreements have differed from the structure of strategic acquisition agreements.

C. The Structure of Acquisition Agreements in Private Equity Transactions

The discussion in Part I.B describes the general architecture of a vast majority of acquisition agreements. However, there have traditionally been significant differences between acquisition agreements used in financial transactions involving private equity buyers and those in strategic transactions. These differences are necessitated by two important characteristics in private equity buyouts of public companies. First, private equity buyers typically use a newly-formed special purpose acquisition vehicle to purchase a company. The shell buyer is generally the only buyer entity party to the acquisition agreement so as to limit the seller’s recourse to the private equity firm for breaches of the agreement. Second, in acquiring a large public company, private equity firms often do not use their own equity or cash to finance the entire purchase price of the

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85 See Michael Aiello et al., Outline for Key Issues in Negotiation: Will the Pendulum Swing? Panel of the Private Equity Presentation, in Going Private: Doing It Right 2009 (PLI Corp. Law & Practice, Course Handbook Series No. 18768, February 26, 2009). The most highlighted example of this approach during the private equity boom was the March 2005 $11.3 billion acquisition of SunGard Data Systems, Inc. by a private equity consortium. See Davidoff, supra note 7, at 114-116; Paul D. Ginsberg et al., Shifting the Risk: an Evolving Approach to Financing Contingencies in LBO Acquisition, THE M&A LAWYER, March 2006 at 4; see also Martin Sikora, LBO Funds Offer Incentives to Drive High-Priced Deals, MERGERS & ACQUISITIONS, Sept. 2005, at 18 (describing SunGard transaction as “a major shift from traditional leveraged dealmaking”).
acquisition. More commonly, the transaction is a leveraged buyout ("LBO"), whereby the shell buyer draws on financing from two separate sources, equity financing commitments from the private equity firms and debt financing commitments from a consortium of lenders. Therefore, in order to complete a typical LBO transaction the shell buyer must receive equity financing from the private equity funds involved in the transaction and loans from a syndicate of banks.

In the vast majority of private equity transactions, the buyers obtain, prior to signing the acquisition agreement, debt commitment letters signed by the lenders. Sellers insisted on debt commitment letters because of a perception that the third party debt financing used by private equity buyers, as opposed to strategic ones, was riskier to the selling company. Generally, both the debt and equity commitment letters include certain conditions to the funder’s obligation to finance the transaction, including conditions regarding adverse changes in the seller or financing markets, additional diligence and finalization of definitive documentation and “marketflex” provisions allowing the lender or underwriter to alter the pricing, structure and terms of the commitment in order to achieve a successful syndication. Accordingly, despite the receipt of a debt commitment letter, there remained a risk that the lenders would attempt to change the terms of the financing, or more drastically, would refuse to provide the financing. The traditional structure of acquisition agreements in LBOs therefore included specific provisions to address the financing risks inherent in these transactions.

87 See Bartlett, supra note 104, at 26-27.
88 In a typical transaction, to complete the merger, the shell buyer then transfers the funds to the target company in order for the exchange with the target company’s shareholder of their target shares for cash. The complex movement of funds is described in detail in a funds flow memo or chart that is prepared by the private equity firm, their lawyers and their accountants.
89 See Davidoff, supra note 7, at 111-112.
90 The debt commitment letter negotiated by the sponsor, and later the target, was designed to reduce the conditionality of the disbursement and line these terms up with the underlying acquisition agreement. See Regner, supra note 122, at 2; Davidoff, supra note 7, at 112.
91 See Davidoff, supra note 7, at 112-113.
1. Traditional Methods for Addressing “Financing Risk”

Because of risks attached to reliance on outside financing, for years private equity buyers sought to include provisions in the acquisition agreement that would allow them to retain the ability to terminate the agreement in the event the financing necessary to effect an LBO structure could not be attained on the expected terms. Sellers agreed to this provide the private equity buyer with a “financing out” despite the fact that “historically strategic deals were structured without a financing condition and with an express provision entitling both parties to specific performance.”

Prior to 2005, an important component of acquisition agreements in private equity sponsored LBOs was the “financing out” or conditions to the buyer’s obligation to close an acquisition based on the availability of debt financing. The financing condition was especially important to private equity firms because they were in the business of buying companies using debt financing, and hence stood to lose a lot of money without this leverage if forced to go through with a deal.

The financing conditions in LBO acquisition agreements necessarily involved an allocation of risk between private equity buyers and target company sellers. As explained above, sellers place heavy emphasis on certainty of closing of the transaction. The private equity buyer, on the other hand, seeks to find assurance in the agreement regarding both the circumstances in

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92 Graham & Vaiana, supra note 114.
93 John G. Finley, Evolving Agreements Offer Flexibility in Credit Crunch, N.Y. L.J., July 30, 2009.
94 The typical financing condition states the following as a condition to the buyer’s obligation to close the transaction: “Financing. The Buyer shall have obtained the financing described in the Commitment Letters on the terms set forth in the Commitment Letters and on such other terms as are reasonably satisfactory to the Buyer.” See 2007 ABA Deal Points Study, supra note 43. The 2007 ABA Deal Points Study found in an analysis of 79 deals announced in 2005 and 2006 that in 2005 48% included a financing condition, but just one year later only 23% included a financing condition.
95 More recently, especially in the period of relatively easy access to credit, private equity firms were even willing to enter into acquisition agreements without any financing condition and without any specific provision that would allow the buyer to walk away from the transaction in the event that financing could not be obtained.
96 See supra notes 35 to 39 and accompanying text.
which it can terminate the agreement if the assumptions on which it agreed to buy the business have materially changed and the maximum amount of liability in the event the buyer terminates the agreement.

There were a number of reasons why sellers agreed to shoulder some of the risk associated with the financing in acquisition contracts. First, sellers agreed to transactions with “financing outs,” which exposed them to increased uncertainty about the probability that a deal would go through, but insisted on covenants that required the shell buyer to engage in a “good faith” effort, or more often “reasonable best efforts” to obtain the necessary financing. Of course, the enforceability of such covenants has been uncertain given that the shell subsidiaries were empty acquisition vehicles and would be unable to complete the acquisition without the parent private equity firm. Hence, one could argue that the financing out served as insurance for a private equity buyer and little more than a false sense of security to targets. In retrospect, as articulated by Professor Davidoff, attorneys for sellers, along with their clients, actually relied on the private equity firm’s reputation as collateral, believing that the implications of walking away from a deal would motivate private equity firms to voluntarily cooperate in using best efforts to obtain financing.

In addition to financing-related covenants, sellers agreed to bear the financing related risk by including a specific performance remedy in the acquisition agreement. As discussed above,

97 See Davidoff, supra note 7, at 134.
98 Id. at 143. This problem was coupled with the fact that the Delaware courts have yet to substantively define the meaning of reasonable best efforts. Id. at 134.
99 See Davidoff, supra note 7, at 105, 122; see also, Graham & Vaiana, supra note 114(stating that private equity buyers would be unlikely to rely on financing conditions as they cannot “afford to be seen as the high risk choice in a competitive auction-as that reputation would put pressure on other deal terms, particularly price.”). Of course, it may be that the seller’s reliance on reputation was not wholly irrational. Private equity firms may have an incentive to achieve a high reputation by investing their committed capital and completing acquisition deals. This commitment to completing transactions may be beneficial to the private equity firm in a number of ways. A recent study by Demiroglu and James found that LBOs initiated by Private Equity firms with good reputation typically pay narrower loan spreads, have fewer, less restrictive loan covenants, utilize less traditional bank debt, and borrow more at a lower cost from institutional loan markets. See Demiroglu and James, supra note 105 at 4.
courts have been known to grant specific performance in the merger context, at least in strategic transactions.\(^{100}\) There is also an argument that a specific performance provision may have the effect of reducing the probability of a breakdown in the transaction prior to closing of the acquisition, thereby potentially reducing deal uncertainty.\(^{101}\)

Nevertheless, it is unclear whether this specific performance remedy had any real value since most agreements were between the shell buyer and the seller. In order for a specific performance provision to work under the traditional private equity structure, the seller would need not only to be successful in persuading a court to order the buyer to perform its covenants under the acquisition agreement, but it would also need for the shell buyer “to cause its parent . . . to fund its equity commitment and . . . to . . . [cause] its debt financing sources to live up to their financing commitments, complete definitive [financing] documentation, and fund the debt financing” before the expiration date of the debt commitment letters.\(^{102}\) This seems hardly realistic and there was no history of successful litigation in the courts.

2. The Private Equity Boom of 2005-2007 and the Use of Reverse Termination Fees

\(^{100}\) IBP, Inc. v. Tyson, Inc., 789 A.2d 14(Del. Ch. 2001); see also Genesco, Inc. v. The Finish Line, Inc., et al., No. 07-2137-11 (III) (20\(^{th}\) Div. Tenn. Ch. 007).

\(^{101}\) See Listokin, supra note 53, at 5 (explaining that market may have reacted positively to specific performance remedy in IBP v. Tyson because when there is a high risk of underperformance, “specific performance reduced the probability of bargaining breakdowns in a bilateral monopoly setting between two hostile parties and mitigated principal-agent conflicts that might have impeded an efficient merger.”).

\(^{102}\) Malcolm Landau et al., A Closer Look at Reverse Termination Fees and Exclusive Remedy Provisions, WEIL BRIEFING: MERGERS AND ACQUISITIONS (Nov. 29, 2007). It is not clear that practitioners realized the weakness in the specific performance remedy in the LBO structure prior to 2007. As stated by Professor Davidoff, despite including a specific performance remedy in acquisition agreements “attorneys failed to fully account for the problems with enforcing this arrangement through shell subsidiaries, the lack of judicial precedent governing enforcement of this mechanism, and the difficulty of forcing shell subsidiaries to enforce debt and equity commitment letters with differing choice-of-law and choice-of-forum clauses.” In the author’s experience, the specific performance remedy was included in a provision in the miscellaneous section of the acquisition agreement, and there was little, if any, discussion or negotiation of this section in practice.
The period of 2005 to 2007 witnessed an explosion of transactions involving public corporations “going private.” Private equity firms armed with billions in funds and aided by relatively easy acquisition financing, heartily courted public companies, which were happy to choose among the competing consortia of high-profile suitors. By 2007, private equity transactions dominated the financial press as the number and values of these transactions became increasingly large. Even the leading public companies considered going private.

Out of this wave of going private-transactions arose a new set of deal terms that differed significantly from traditional terms in private equity sponsored LBOs. Starting in 2005, RTF provisions proliferated in an environment in which seller boards were much more likely to agree to a deal with a private equity suitor than with a strategic buyer. An early study of 79 acquisition agreements in private equity buyouts of U.S. publicly-traded companies during 2005 and 2006 showed that nearly half of the deals required the buyer to pay an RTF for breach or failure to obtain financing. A more recent estimate found that by 2007, over 80% of private

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106 Matt Krantz, First Data Deal Shows Big Private Equity Clout: Any Public Company Could Become a Target, USA TODAY, Apr. 3, 2007, at B1; see also Steve Rosenbush, Deals of the Year, in a Year of Deals, BUSINESSWEEK, Dec. 19, 2006 (observing that after 2004, “[s]trategic buyers [had] a hard time competing against private equity firms.”);
107 See, e.g., In re Netsmart Tech., Inc. S’holders Litig., 924 A.2d 171, 198 (Del. Ch. 2007) (stating, “[S]trategic buyers might sense that CEOs are more interested in doing private equity deals that leave them as CEOs than strategic deals that may . . . not.”); In re Lear, 926 A.2d 94 (Del Ch. 2007).
108 See 2007 ABA Deal Points Study, supra note 43, at 52 (finding that 46% of the surveyed transactions included RTFs).
equity acquisitions of public companies used an RTF structure.\textsuperscript{109} The use of RTF provision significantly transformed the traditional structure of private equity transactions.\textsuperscript{110} As I argue in Part III, critical provisions addressing risk allocation in private equity transactions have migrated into strategic transactions.

The increasing use of RTFs in private equity transactions was tied to the leveraged financing structure of private equity buyouts of public companies and the particularly unusual period of easy access to credit, as well as to the structure of acquisition agreements in these deals. Given the easier access to credit, deal terms, such as “financing outs,” that had been used to shield private equity buyers from the risks involved in obtaining the financing needed to complete the transaction were largely abandoned.\textsuperscript{111}

Instead of relying on “financing outs,” this new breed of private equity acquisition agreements typically provided that buyers could refuse to close an acquisition subject to payment of an RTF. In most private equity acquisition agreements, the RTF provision was structured as a liquidated damages clause and was typically coupled with a bar on specific performance. In addition, similar to the amount of the STF, most private equity acquisition agreements provided for RTFs that typically ranged around 3 percent of a transaction’s equity value.\textsuperscript{112} This meant that in the event that private equity buyers refused to close the transaction for any reason, the seller’s sole and exclusive remedy was limited to the RTF. In some contracts, the RTF even served as a cap on damages that would needed to have been proven in litigation.

\textsuperscript{109} See Davidoff, supra note 7, at 117.

\textsuperscript{110} See Davidoff, supra note 7 (chronicling changes in traditional private equity deal structure, and setting forth reasons for ultimate failure of structure and role that lawyers played in this phenomenon).

\textsuperscript{111} According to a 2007 ABA study of key deal points in financial sponsor-backed acquisitions of publicly traded companies announced in 2005 and 2006, more than three-fourths of the 2006 acquisition agreements in the Study did not contain a financing condition. See 2007 ABA Deal Points Study, supra note 43, at 25.

\textsuperscript{112} See, e.g. Michael Weisser & Matthew Cammack, Shepherding the Deal, THE DEAL, Mar. 30, 2007. See also Houlihan Lokey, supra note 66 at 7.
Selling companies agreed to the RTF provision with an expectation that private equity buyers would likely not walk away from the transaction because of reputational forces, or that they would at least receive a hefty fee in exchange if buyers nonetheless walked away from the acquisition. In fact, many commentators initially argued that RTF provisions were “seller friendly” and that private equity buyers agreed to the provision in order to make their offers more appealing to sellers. These arguments were based on the conclusion that RTF provisions were less risky for sellers than “financing out” provisions.

The view that the RTF structure was less risky was tied to concerns about the uncertainty involved in an acquisition agreement with a “financing out” and a specific performance remedy enforceable only against a shell buyer. Boards were particularly concerned about the structure of private equity agreements given that they generally had full recourse against the assets of a strategic buyer in the event of a breach of the agreement, as well as the ability to seek specific performance by the strategic buyer. Sellers and their lawyers argued that a contract with an RTF provision provided a potentially more favorable remedy than the traditional structure of private equity acquisition agreements. In fact, even after the advent of the broken deals of 2007 and 2008, lawyers for target companies continued to assert that, not only were boards

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113 See Choi & Triantis, supra note 12, at 12 (stating, “Practitioners refer to low-optionality as seller friendly, and to broader, cheaper optionality as buyer friendly”).
114 See Tucker & Yingling, supra note 74, at 70; see, e.g., Paul S. Bird & Jonathan E. Levitsky, Deals Redefined, THE DEAL, Dec. 18, 2007 (noting that “[c]onventional wisdom suggested that private equity firms had been forced to accept a number of seller-favorable terms, including the disappearance of financing conditions”); John L. Graham & Bradley C. Vaiana, Mergers & Acquisitions: Rolling the Dice, N.Y. L.J., Nov. 7, 2005 (stating, “Ironically, this proliferation of mega-deals has also been accompanied by an erosion of deal terms that traditionally served to protect private equity sponsors from the risk of obtaining financing.”).
115 See Davidoff, supra note 7, at 140.
116 Davidoff, supra note 7, at 137. The removal of the financing condition presented another benefit for seller boards in that they could tout to the public and their shareholders that they had entered into an acquisition transaction that was not subject to financing.
aware of the optionality of the RTF structure, but that these structures “were improvements upon the pre-2005 model, which simply specified a financing condition.”

3. From Boom to Bust

The days of relatively easy courtships between public company sellers and private equity came to a sudden halt in mid-2007. As the credit crisis crystallized in 2007 and 2008 an unprecedented number of private equity firms did the unexpected—they attempted to terminate deals for which they could not obtain financing, and, in some cases, deals were terminated even when financing was available.

Not surprisingly, litigation ensued when private equity buyers attempted to terminate acquisition agreements. Some private equity buyers countered that a MAC with respect to the seller had occurred so that they could walk away without penalty. Others argued that because the agreement provided for an RTF, they had contracted for what amounted to an option to pay a fee and refused to close the transaction. The MAC maneuver was not a new one; almost all

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117 Davidoff, Breakup Fees, supra note 126.
119 See Nowicki, supra note 39, at 4.
122 See, e.g., William Regner et. al., The “Downturn” Roadmap: Parsing the Shift in Deal Terms, DEAL LAWYERS, Sept.–Oct. 2007, at 2 (stating, “Some agreements made it clear that the [reverse] termination fee really is the only remedy and that the acquisition agreement is nothing more than an option.”); Megan Davies & Michael Flaherty, As Deals Crumble, Break-up Fees in Spotlight, REUTERS: DEALTALK (Nov. 29, 2007) (stating, “‘What am I missing? This is an option’ to back out, one private equity investor told Reuters, referring to when he first came upon reverse break-up fee clauses.”).
acquisition agreements involving a public company have long provided that the buyer can refuse to close thetransaction if a MAC occurs with respect to the selling company. The utilization of the RTF, on the other hand, was a new beast altogether.

These broken deals led to heated disputes between buyers and sellers that played out in the press and in the Delaware courts. Many sellers claimed that the RTF provision was not what they had bargained for and expressed shock that it would be exercised like an option.123 Private equity buyers, on the other hand, insisted that the optionality was exactly what they had bargained for. “For buyers, compared to a market with no available liquidity, an inability to syndicate transaction debt, and resulting immediate writedowns often in the billions, the loss of even hundreds of millions was seen as potentially acceptable or, occasionally, preferable.”124 In a number of prominent disputes, the RTF structure thus permitted the buyer to walk away from the transaction pursuant to the terms of the contract. Sellers were thus “left at the altar” with stock prices that “languished significantly below their pre-bid levels.”125

Once it became clear that the RTF structure could be used like an option to refuse to close a deal, criticism of the provision abounded.126 Many commentators believed that the provision would largely disappear from acquisition agreements – that sellers, in particular public

123 “An option is a contract that gives its owner the right to buy or to sell an asset at a prespecified price. . . . An option to buy the specified items at a fixed price is a call option.” Aziz Bodie & Robert Merton, Finance 384 (2000). One can think of the acquisition agreement with an RTF provision as a call option being sold to the buyer if one thinks of it in the following way: (i) the fee is the option price (C); the strike price is the deal price minus the fee (S). In this way, the seller always obtains C. The buyer purchases the selling firm if the value of the selling (V) is above the strike price at the time of closing. Thus, the payoff to the buyer, after taking into account the option price is max{0,V-S}.
125 Nowicki, supra note X, at 5.
126 See, e.g., Steven Davidoff, Where Do Breakup Fees Go From Here?, The Deal Professor, N.Y. TIMES, Apr. 7, 2008 (hereinafter Davidoff, Breakup Fees).
companies, would likely negotiate for greater certainty in acquisition agreements. At the very least, commentators hoped that sellers would bargain for higher RTFs and make deliberate decisions about the risks attached to such provisions.

The prediction that RTFs would be abandoned has so far proven premature. In fact, RTF provisions are continuing to be used in private equity acquisitions of public companies. What we have seen thus far, although deal-making has fallen significantly from the heights of early 2007, is the endurance of RTF provisions in private equity buyouts. The continued use of RTFs in private equity transactions, including the option-style structure, was noted in a survey of 39 private equity acquisitions of private companies announced from January 1, 2008 to December 31, 2008. The study found that in 23% of the surveyed transactions, sellers negotiated for monetary remedies in addition to the RTF, typically in “circumstances where the buyer intentionally breached its obligations to consummate the transaction despite the

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130 See Weil, Gotshal & Manges Private Equity Group Survey, *Sponsor-Backed Going Private Transactions* 17 (March 2009) (finding the reverse termination in 87% of all surveyed transactions); see also, Steven Davidoff, *A New Approach to Deal Uncertainty*, The Deal Professor, N.Y. TIMES, Apr. 27, 2009 (stating that private equity deals announced since the financial crisis “have largely hewed to the pure form of reverse termination fee structure [which] permit the private equity buyers to walk for any reason, with their liability capped at about 3 percent of the transaction price.”). While the private equity deals of 2008 appeared to hew closely to the model used in the 2005-07 period, there does appear to be some movement in the structure in several transactions that were announced in the second and third quarter of 2009. See Steven Davidoff, *Bankrate: A New Model for Private Equity Deals*, The Deal Professor, N.Y. TIMES, July 24, 2009 (stating that targets are now demanding less-optional deals).
availability of financing.” In addition, in over 90% of surveyed transactions the seller was not permitted to seek specific performance and its contractual remedy was limited to the RTF or monetary damages.

Furthermore, as demonstrated in the empirical study undertaken by this Article, there is an emerging trend in strategic deals in which strategic buyers are utilizing the reverse termination structure used in private equity deals.

II. **Empirical Study of Reverse Termination Fees in Strategic Transactions**

This Article’s empirical study of acquisition agreements in strategic transactions announced between January 1, 2003 and December 31, 2004 demonstrates the use of RTF provisions to allocate a limited subset of deal risks faced by the parties to the transaction. Section A below sets forth the results of a contract by contract review of agreements in 90 transactions announced during the 2003 to 2004 period. Section B provides the results of this review from 76 strategic transactions announced between January 1, 2008 and June 30, 2009, and provides a comparison of with the results from the 2003-2004 period. The comparison shows that RTFs are now used more often and are payable under a greater variety of conditions.

A. The Limited Use of Reverse Termination Fees in Strategic Transactions in 2003 and 2004

Between January 1, 2003 and December 31, 2004, 90 of the 532 strategic transactions reviewed, or approximately 16.9%, included an RTF. An analysis of each of these agreements demonstrates that parties predominantly used RTF provisions to allocate similar risks to those allocated by STFs, such as the risk that the buyer would terminate the agreement due to a superior proposal for the buyer. In a substantial majority of the reviewed agreements, the RTF

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131 Id. at 18.
132 Id. at 20.
was equal to the STF. However, the vast majority of these agreements continued to include the remedy of specific performance in lieu of the RTF provision.

1. Reverse Termination Fee Triggers

In terms of triggers in these strategic deals, while STFs are generally triggered by some combination of a termination and a competing acquisition proposal from a third party, RTFs are somewhat, although not substantially, more varied.

Table 1 below presents a summary of the frequency of the most common RTF triggers in the 90 contracts reviewed for the 2003-2004 period. The most common RTF triggers in the 2003-2004 strategic deals were, in order of frequency, (1) Termination in connection with a competing transaction for the buyer,\(^{133}\) (2) Changes in the Buyer’s Board Recommendation (not related to a competing offer), (3) Buyer’s Incurable Breach of Representations and Warranties or Covenants (not related to a competing offer), (4) Failure to Obtain Shareholder Approval or Hold a Shareholder Meeting (not related to a competing offer), (5) Failure to Obtain Regulatory Approval, (6) Merger not Consummated (for any reason), or (7) Failure to Obtain Financing. The data shows that parties generally used RTF provisions for the same reasons that they use STF provisions—to allocate the risk that the buyer would terminate the agreement due to a superior proposal for the buyer or the risk that the buyer’s board or shareholders would not approve the transaction. Under these circumstances, one would expect that the RTF would be equal to the STF.

\(^{133}\) In a significant number of transactions, an RTF is triggered when the buyer elects to terminate the acquisition because of one or more of the following scenarios, each related to a competing transaction for the buyer: (i) the buyer board elects to terminate the acquisition agreement in order to accept a competing offer for the buyer; or (ii) the buyer board changes its recommendation in connection with a competing offer for the buyer; or (iii) the transaction fails for some other specified reason, such as being voted down by the shareholders or the passing of a drop dead date or a breach of representation and warranties, after a competing proposal has been announced and is agreed to or closed within a specified period of time (typically 6-12 months); or (iv) buyer’s violation of the no-solicitation clause.
Table 1

<table>
<thead>
<tr>
<th>Reverse Termination Fee Triggers</th>
<th>% (#) of Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Termination in Connection with a Competing Transaction for Buyer</td>
<td>53.3% (48)</td>
</tr>
<tr>
<td>Change in Board Rec</td>
<td>42.2% (38)</td>
</tr>
<tr>
<td>Buyer’s Incurable Breach of R&amp;W/Covenants /Agreements</td>
<td>26.7% (24)</td>
</tr>
<tr>
<td>Failure to Obtain a SH Vote/Hold SH Meeting</td>
<td>20.0% (18)</td>
</tr>
<tr>
<td>Failure to Obtain Regulatory Approval</td>
<td>10.0% (9)</td>
</tr>
<tr>
<td>Merger not Consummated (for any reason)</td>
<td>7.8% (7)</td>
</tr>
<tr>
<td>Financing Failure</td>
<td>6.7% (6)</td>
</tr>
</tbody>
</table>

Table 2 presents a summary of the relationship between the RTF and the STF with respect to each trigger. Overall, in approximately 80% of all transactions the amount of the RTF was equal to that of the STF. The fact that RTFs were set at the same amount as STFs in the vast majority of transactions appears to be an expected consequence of the fact that the triggering conditions for the two fees were identical. Moreover the data shows that in the transactions where the fee was triggered because the merger was not consummated for any reason, the RTF was in general higher than the STF.

Table 2

<table>
<thead>
<tr>
<th>Reverse Termination Fee Triggers</th>
<th>% (#) of Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Termination in Connection with a Competing Transaction for Buyer</td>
<td>48</td>
</tr>
<tr>
<td>Change in Board Rec</td>
<td>38</td>
</tr>
<tr>
<td>Buyer’s Incurable Breach of R&amp;W/Covenants/Agreements</td>
<td>24</td>
</tr>
<tr>
<td>Failure to Obtain a SH Vote/Hold SH Meeting</td>
<td>18</td>
</tr>
<tr>
<td>Failure to Obtain Regulatory Approval</td>
<td>9</td>
</tr>
<tr>
<td>Merger not Consummated (for any reason)</td>
<td>7</td>
</tr>
<tr>
<td>Financing Failure</td>
<td>6</td>
</tr>
</tbody>
</table>

RTF = STF 89.6% (43) 86.8% (34) 75.0% (18) 77.8% (14) 44.4% (4) 0.0% (0) 83.3% (5)
STF > RTF 2.1% (1) 10.5% (4) 8.3% (2) 22.2% (4) 44.4% (4) 14.3% (1) 0.0% (0)
RTF > STF 0.0% (0) 0.0% (0) 8.3% (2) 0.0% (0) 11.1% (1) 71.4% (5) 16.7% (1)
2-Tiered RTF 8.3% (4) 0.0% (0) 4.2% (1) 0.0% (0) 0.0% (0) 0.0% (0) 0.0% (0)

In one of the agreements, the amount of the RTF was not disclosed in either the acquisition agreement or the company’s public disclosure. See Agreement and Plan of Merger, Prime Medical Services, Inc., ABC Merger, Inc. § 10.2 (Nov. 11, 2003).
2. Remedies

In 72 out of 90, or approximately 79%, the contract gave both sellers and buyers a variety of remedies, including the ability to press for damages or specific performance. Because these deals included both RTFs and the availability of contract damages or specific performance, under such contracts a breaching buyer could not simply terminate the transaction and pay a fee. Furthermore, the reverse termination was only payable if the seller, as the non-breaching party, terminated the agreement. Hence, in the event of a buyer’s willful breach of any covenants, the seller could elect to sue for specific performance or terminate the agreement and collect the fee.

Johnson & Johnson’s attempted acquisition of Guidant Corporation in December 2004 exemplifies such an arrangement. In this transaction, the RTF trigger was conditioned on the non-breaching seller terminating the acquisition agreement in the event the merger was not consummated by a given date. The contract provided that either Johnson & Johnson or Guidant could terminate the deal and pay the termination fee:

[I]f the Merger shall not have been consummated on or before February 28, 2006; provided, however, that the right to terminate this Agreement . . . shall not be available to any party whose willful breach of a representation or warranty in this Agreement or whose other action or failure to act has been a principal cause of or

135 The Johnson & Johnson – Guidant merger was ultimately terminated because a third-party acquirer, Boston Scientific, made a bid for Guidant after Johnson & Johnson alleged that a MAC had occurred and renegotiated a lower purchase price for Guidant. A bidding war ensued between Johnson & Johnson and Boston Scientific, with the latter ultimately prevailing. There was no news or commentary on the RTF and it appears that Johnson & Johnson’s waffling on the original deal was primarily aimed at lowering the purchase price because of a variety of legal issues with Guidant’s defibrillators and pacemakers. See Kerry Dooley Young, Johnson & Johnson’s Second-Qtr Profit Rises on Medical Devices, BLOOMBERG NEWS, Jul. 19, 2005, http://www.bloomberg.com/apps/news?pid=10000103&sid=aQY0BlkbuqB8&refer=us.
resulted in the failure of the Merger to be consummated on or before such date.\textsuperscript{136}

Thus, if Johnson & Johnson tried to abandon the deal through some willful breach of its representations or warranties or covenants, it would not have been allowed to simply terminate the agreement and pay the RTF. Guidant would have had the option to terminate the agreement, whereupon it could demand the RTF from Johnson & Johnson, or, alternatively, attempt to force Johnson & Johnson to consummate the agreement by suing for specific performance.

A number of agreements in the 2003-2004 period were narrowly tailored contracts that provided that the RTF was the seller’s sole and exclusive remedy in the event the fee was triggered but that limited the means through which a buyer could engineer the triggering of the fee. For example, in the $78 million cash acquisition by Psychiatric Solutions, a Tennessee operator of mental health centers, of Ramsay Youth Services, a Florida provider of mental health services in residential and non-residential settings,\textsuperscript{137} the contract provided that the RTF would be triggered in the event that the buyer failed to obtain financing for the transaction.\textsuperscript{138}

The contract in this deal established a narrow set of walk rights for the buyer. Psychiatric Solutions would have to fail to obtain financing for the transaction before the RTF would be triggered. However, this walk right was considerably narrowed by contractual language that compelled Psychiatric Solutions to use its “best efforts promptly to obtain and deliver to (Ramsay) a binding commitment letter from a nationally recognized financial institution to

\textsuperscript{136} Agreement and Plan of Merger, Johnson & Johnson, Shelby Merger Sub, Inc. and Guidant Corporation § 7.01(b)(i) (December 15, 2004).
\textsuperscript{137} Press release, Psychiatric Solutions Signs definitive agreement to acquire Ramsay Youth Services in $78 million transaction, April 9, 2003, http://www.sec.gov/Archives/edgar/data/829608/000095014403004763/g81928exv99w1.txt
\textsuperscript{138} See Agreement and Plan of Merger, Ramsay Youth Services, Inc., Psychiatric Solutions, Inc., and PSI Acquisition Sub, Inc. § 8.02 (April 8, 2003).
provide the Financing.” As such, it would have been difficult for Psychiatric Solutions to engineer a financing failure for the purposes of abandoning the transaction without violating the express terms of the contract. Moreover, to trigger payment of the RTF, Ramsay would have had to terminate the agreement due to the financing failure. In such an event, the contractual language in section 8.02(f) provided that “if this Agreement shall have been terminated pursuant to Section 8.01(f) [failure to obtain debt commitment letter] or (h) [failure to consummate financing], then the Purchaser shall pay the Company an amount equal to the Break-up Fee [i.e., the RTF].” The contract further provided that “the payment of any Break-up Fee and/or expenses [pursuant to 8.02(f)] shall be full compensation for the loss suffered by . . . the Company . . . as a result of the failure of the Merger to be consummated.” Thus, Ramsay Youth arguably could not sue for specific performance upon the triggering and payment of the reverse termination. However, the seller in this transaction had license to determine the appropriateness of the financing conditions and thereby retained control over the buyer’s ability to leave the deal.

The most extreme use of the RTF structure – the option-style RTF – was seldom used in the 2003-2004 period. Only 8, or approximately 8.8%, of the contracts reviewed could arguably be interpreted as option-style deals whereby the RTF was the seller’s sole and exclusive remedy in the event that the transaction failed to close due to a breach by the buyer. In these agreements,

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139 Id., at § 6.07.
140 Id. at §§ 8.01(f), (h).
141 Id., at § 8.02(f).
142 Id., at § 8.02(g).
143 I use the word arguably because the drafting of the contract is less than clear. For example, while Section 8.02(g) states that the payment of the fee is full compensation for losses suffered by the seller, Section 9.06 provides for the remedy of specific enforcement.
144 Of these transactions, only two of the agreements, gave buyers generous room to engineer a breach for the purposes of terminating the deal and walk away from the transaction upon payment of the RTF. See, Agreement and Plan of Merger, TXU Gas Company and LSG Acquisition Corporation, § 10.02 (June 17, 2004) (on file with the SEC as Exhibit 2.1 to Form 8-K). In the Atmos, TXU transaction, based on the contractual language, if the buyer
the RTF triggers included events that the buyer could control. For example, the most common triggers included: (1) a breach of the buyer’s representations and warranties or covenants under the agreement or (2) a failure to close by the “drop dead” date after all conditions to the closing are satisfied.

While the option-style structure was rarely used in strategic deals in the 2003-2004 period, the study in Part II.B demonstrates that it has become more commonly used in the strategic transactions in the 2008-mid 2009 period.

B. The Transformation of Reverse Termination Fees in Strategic Transactions in 2008 through Mid-2009

This Article’s empirical study of acquisition agreements in strategic transactions announced between January 1, 2008 and June 30, 2009 demonstrates the use of RTF provisions by parties to allocate a variety of deal risks. Of the 291 strategic transactions reviewed for this period, 76 agreements, or approximately 26.1%, included an RTF. This is a significant increase from only 16.9% of transactions in the 2003-2004 period. The data also shows that while in some transactions RTFs continue to be set at an equal amount to STFs, parties have also become more creative by using hybrid and liability cap approaches in their use of the fee as a seller’s remedy.

1. Reverse Termination Fee Triggers

Table 3 below presents a summary of the frequency of the most common RTF triggers in the 76 contracts reviewed for the 2008 to June 30, 2009 period. In terms of triggers in these strategic deals, the most common RTF triggers in the 2008-mid 2009 period were, in order of frequency, decided to terminate the agreement, it would have to do no more than simply wait for the drop dead date to lapse, pay the termination fee and walk away from the acquisition and the seller would have no additional recourse against the buyer. See id. (“Upon payment by (Atmos) of such amount, (Atmos) will be fully released and discharged from any liability or obligation resulting for its failure to close the transactions contemplated by this Agreement.”); see also Agreement and Plan of Merger, D&K Healthcare Resources, Inc., D&K Acquisition Corp., and Walsh HealthCare Solutions, Inc., § 8.6 (October 21, 2003) (on file with the SEC as Exhibit 2.1 to Form 8-K).
(1) Buyer’s Incurable Breach of Representations and Warranties or Covenants (not related to a competing offer), (2) Termination in Connection with a Competing Transaction for the Buyer, (3) Changes in the Buyer’s Board Recommendation (not related to a competing offer), (4) Merger not Consummated (for any reason), (5) Failure to Obtain Financing, (6) Failure to Obtain Shareholder Approval or Hold a Shareholder Meeting (not related to a competing offer), and (7) Failure to Obtain Regulatory Approval. Moreover, in a significant percentage of transactions, the fee was triggered in circumstances that were unrelated to a competing transaction for the buyer, such as in the event of the buyer’s incurable breach of its representations and covenants, if the merger was not consummated for any reason or in the event that the buyer was unable to obtain financing. One would expect that under such circumstances the RTF would be higher than the STF.

Table 3

<table>
<thead>
<tr>
<th>Reverse Termination Fee Triggers</th>
<th>Buyer’s Incurable Breach of R&amp;W/Covenants/Agreements</th>
<th>Termination in Connection with a Competing Transaction for Buyer</th>
<th>Change in Board Rec</th>
<th>Merger not Consummated (for any reason)</th>
<th>Financing Failure</th>
<th>Failure to Obtain a SH Vote/Hold SH Meeting</th>
<th>Failure to Obtain Regulatory Approval</th>
</tr>
</thead>
<tbody>
<tr>
<td>% (#) of Contracts</td>
<td>40.8% (31)</td>
<td>39.5% (30)</td>
<td>38.2% (29)</td>
<td>34.2% (26)</td>
<td>23.7% (18)</td>
<td>17.1% (13)</td>
<td>13.2% (10)</td>
</tr>
</tbody>
</table>

A comparison of our findings from the 2003-2004 period to the 2008-mid 2009 period demonstrates that strategic buyers used RTFs to allocate deal risk beyond just the risk of non-consummation due to a competing offer for the buyer. Table 4 below presents a comparison of the use of each of the 7 identified triggers. Table 4 demonstrates that in the 2008-mid 2009 period buyers used RTF triggers more often than in 2003-2004 in order to (i) walk away from the transaction for any reason, or (ii) terminate the transaction due to a failure to obtain financing.
<table>
<thead>
<tr>
<th>Termination in Connection with a Competing Transaction for Buyer</th>
<th>2003-2004</th>
<th>2008-Mid 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>53.3%</td>
<td>39.5%</td>
</tr>
<tr>
<td></td>
<td>(48)</td>
<td>(30)</td>
</tr>
<tr>
<td>Change in Board Rec</td>
<td>42.2%</td>
<td>38.2%</td>
</tr>
<tr>
<td></td>
<td>(38)</td>
<td>(29)</td>
</tr>
<tr>
<td>Buyer’s Incurable Breach of R&amp;W/Covenants/Agreements</td>
<td>26.7%</td>
<td>40.8%</td>
</tr>
<tr>
<td></td>
<td>(24)</td>
<td>(31)</td>
</tr>
<tr>
<td>Failure to Obtain a SH Vote/Hold SH Meeting</td>
<td>20.0%</td>
<td>17.1%</td>
</tr>
<tr>
<td></td>
<td>(18)</td>
<td>(13)</td>
</tr>
<tr>
<td>Failure to Obtain Regulatory Approval</td>
<td>10.0%</td>
<td>13.2%</td>
</tr>
<tr>
<td></td>
<td>(9)</td>
<td>(10)</td>
</tr>
<tr>
<td>Merger not Consummated (for any reason)</td>
<td>7.8%</td>
<td>34.2%</td>
</tr>
<tr>
<td></td>
<td>(7)</td>
<td>(26)</td>
</tr>
<tr>
<td>Financing Failure</td>
<td>6.7%</td>
<td>23.7%</td>
</tr>
<tr>
<td></td>
<td>(6)</td>
<td>(18)</td>
</tr>
</tbody>
</table>

RTF amounts were also significantly different in the 2008-mid 2009 period. Table 5 shows the relationship between the RTF and the STF with respect to each trigger. In 47 of the 76 contracts, or approximately 61.8%, the RTF mirrored the size and amount of the STF, roughly 1-4% of the transaction value. A significant number of transactions had RTFs that were higher than the STF, particularly in cases where the fee was triggered when the transaction was not consummated for any reason. Moreover, three transactions used a two-tiered RTF structure that gave the buyer a pure walk-away right only if it paid the higher fee. This suggests that parties had a greater awareness of the optionality involved in an agreement where, in the event of a breach of the contract by the buyer, the seller’s only remedy is limited to the RTF.
Table 5

<table>
<thead>
<tr>
<th>Buyer’s Incurable Breach of R&amp;W/Covenants/Agreements</th>
<th>Termination in Connection with a Competing Transaction for Buyer</th>
<th>Change in Board Rec</th>
<th>Merger not Consummated (for any reason)</th>
<th>Financing Failure</th>
<th>Failure to Obtain a SH Vote/Hold SH Meeting</th>
<th>Failure to Obtain Regulatory Approval</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contracts (#)</td>
<td>31</td>
<td>30</td>
<td>29</td>
<td>26</td>
<td>18</td>
<td>13</td>
</tr>
<tr>
<td><strong>RTF = STF</strong></td>
<td>61.3% (19)</td>
<td>66.7% (20)</td>
<td>75.9% (22)</td>
<td>46.2% (12)</td>
<td>77.8% (14)</td>
<td>46.2% (6)</td>
</tr>
<tr>
<td><strong>STF &gt; RTF</strong></td>
<td>19.4% (6)</td>
<td>10.0% (3)</td>
<td>10.3% (3)</td>
<td>7.7% (2)</td>
<td>0.0% (0)</td>
<td>30.8% (4)</td>
</tr>
<tr>
<td><strong>RTF &gt; STF</strong></td>
<td>16.1% (5)</td>
<td>20.0% (6)</td>
<td>13.8% (4)</td>
<td>42.3% (11)</td>
<td>22.2% (4)</td>
<td>15.4% (2)</td>
</tr>
<tr>
<td><strong>2-Tiered RTF</strong></td>
<td>3.2% (1)</td>
<td>3.3% (1)</td>
<td>0.0% (0)</td>
<td>3.8% (1)</td>
<td>0.0% (0)</td>
<td>7.7% (1)</td>
</tr>
</tbody>
</table>

Table 6 below presents a breakdown of the RTF amounts to STFs in the strategic deals reviewed for each period. While in the 2003-2004 period RTFs were most often equal to STFs, the two fees were equal in less than half of all transactions in the 2008-mid 2009 period. Moreover, in over 26% of transactions in the 2008-mid 2009 period, the RTF exceeded the STF, while this held true in approximately 13% of transactions in the 2003-2004 period.

Table 6

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Contracts</strong></td>
<td>90</td>
<td>76</td>
</tr>
<tr>
<td>% (#) RTF = STF</td>
<td>80.2% (73)</td>
<td>61.8% (47)</td>
</tr>
<tr>
<td>% (#) STF &gt; RTF</td>
<td>8.8% (8)</td>
<td>7.9% (6)</td>
</tr>
<tr>
<td>% (#) RTF &gt; STF</td>
<td>13.2% (12)</td>
<td>26.3% (20)</td>
</tr>
</tbody>
</table>

2. Remedies

In 26 of the 76 transactions, or 33.8%, the RTF was the sole and exclusive remedy for the sellers in the event that the deal failed to close due to one of the triggers listed above. Six of these 26 agreements feature RTF provisions which serve as the seller’s sole remedy if the deal is terminated for certain events, such as a failure to obtain financing, but permits the seller to seek the remedy of specific performance for termination under other circumstances.\(^{145}\) In the other 20

\(^{145}\) See, e.g., GSI-Excel Technology deal on Jul. 9, 2008.
transactions, or approximately 26.3%, the RTF structure was an option-style structure which either permitted the buyer to walk for any reason or gave the buyer broad latitude to arrange triggering of the payment of the fee. The language in these contracts closely resembles that found in private equity transactions during the 2005-2007 period. In these deals, specific performance was expressly prohibited as a seller’s remedy. Some agreements went even further and explicitly defined the RTF as liquidated damages intended to be the sole remedy of the seller.  

One of the most significant changes when comparing the results from the 2008-mid 2009 period to the 2003-2004 period is the marked increase in option-style transactions. While only 8.8% of transactions in the 2003-2004 period could be deemed as option-style transactions, 26% of the transactions commenced in 2008-mid 2009 were option-style deals.

The discussion below describes in greater detail the three most common types of RTF and remedy arrangements.

**Option-Style Reverse Termination Fees.** Pure option-style RTFs give the buyer a walk-away right for any reason upon payment of the fee. Under this approach, the seller is not entitled to seek specific performance of the contract if the buyer fails to close the transaction for any reason, including a breach of its covenants under the agreement or failure to obtain financing.

146 The Brocade-Foundry deal incorporates an example of typical contract language which establishes the RTF as liquidated damages and a liability cap, providing in Section 8.3(f) as follows: “Upon payment by Parent of the Reverse Termination Fee . . . neither Parent nor any of its Related Persons shall have any further liability . . . relating to or arising out of this Agreement . . . The parties agree that the Reverse Termination Fee and the agreements contained in this Section 8.3(f) are an integral part of the Merger and the other transactions contemplated by this Agreement and that the Reverse Termination Fee constitutes liquidated damages and not a penalty.” Agreement and Plan of Merger, Brocade Communications Systems, Inc., Falcon Acquisition Sub, Inc. and Foundry Networks, Inc. §8.3(f) (July 21, 2008). This agreement also expressly prohibits specific performance as a seller remedy if the RTF is paid, as evidenced by “Except as set forth in Section 8.3(f), in the event of any breach or threatened breach by the (buyer) or the (seller) of any covenant or obligation of such party . . . the other party shall be entitled to seek . . . specific performance to enforce the observance and performance of such covenant or obligation.” Id. at Sec. 9.12. See also Transaction Network Serv./Verisign Agreement, Sec. 9.03 (c); JDA/i2 Software Agreement Sec. 3.13(a)(i); Chaparral/Edge Petroleum Agreement Sec. 7.3(e). This is by no means an exhaustive list, but rather a sample of a few agreements that incorporate RTFs as liquidated damages.
Furthermore, under this approach, any damages and losses suffered by the seller as a result of the buyer’s breach are limited to the RTF.

The $23 billion acquisition of Wrigley by Mars was one of the most highlighted strategic transactions that used the private equity LBO structure. The merger agreement in this mega-deal gave Mars a walk-away right for any reason, at any time, with the $1 billion RTF as the only penalty for doing so. At the time of the Mars-Wrigley deal in early 2008, commentators wondered whether other strategic buyers would adjust their acquisition structure to mirror the Mars-Wrigley transaction. The Mars-Wrigley transaction has become somewhat of “a model for others in which an industry player has agreed to buy a rival.”

Reverse Termination Fees with Specific Performance – The Hybrid Approach. Parties in other transactions appeared to have carefully negotiated the RTF provisions and the triggers for the buyer’s payment of such fees. These deals appear to be similar to the hybrid structure that was utilized in a few of the private equity buyouts in the 2005-07 period. Under this approach, the use of the RTF as the buyer’s sole liability only arises only under certain circumstances, for example if financing is unavailable to the buyer despite the buyer’s efforts to cause the lenders to fund the acquisition. However, if the buyer wants to walk away from the deal despite the availability of financing, or the buyer breaches the merger agreement in a way that would cause the debt financing to be unavailable, then the seller’s remedies are not limited to the RTF and the seller is entitled to seek specific performance.

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148 See Id.


150 Landau et al., *supra* note 102, at 3.
For example, the $68 billion acquisition of Wyeth by Pfizer conditioned the payment of the RTF on a financing failure. However, perhaps in acknowledgement of marketplace uncertainty, Wyeth narrowed the contract language that gave Pfizer a walk right, and included specific performance as its alternate remedy. The Pfizer-Wyeth transaction limited the circumstances under which a financing failure could be claimed. The financing failure as an RTF trigger occurred only if Pfizer’s lenders withheld financing because Pfizer suffered a credit ratings downgrade. Specifically:

[I]f [Pfizer’s] lenders refuse to finance the transaction and they do so primarily because Pfizer does not have one of: (i) an unsecured long-term obligations rating of at least “A2” (with stable (or better) outlook) and a commercial paper credit rating of at least “P-1” (which rating shall be affirmed) from Moody’s Investors Services, Inc. and (ii) a long-term issuer credit rating of at least “A” (with stable (or better) outlook) and a short-term issuer credit rating of at least “A-1” (which rating shall be affirmed) from Standard & Poor’s.\(^\text{151}\)

Thus, if Pfizer was unable to claim a financing failure, then Wyeth could either sue for specific performance or terminate the agreement and collect the RTF. It is also noteworthy that even if Pfizer was experiencing financing problems, it “[would] not be put in the position of having to close without financing if it cannot find an alternative.”\(^\text{152}\) Rather, Pfizer can be compelled to seek alternate financing until the termination date, upon which it can either close or abandon the deal and pay the RTF. The significance of this provision is that the risk for Wyeth is mitigated to provide the company with adequate closing assurance, unlike in the option-style structure. This


\(^{152}\) Id.
is not to say that the approach followed in the Pfizer-Wyeth transaction does not allow Pfizer “to arrange a financing failure,” through some social or financial manipulation. However, Pfizer would be subject to a massive $4.5 billion RTF that is approximately 7.25 percent of the deal value and half the deal premium. Thus, this RTF was not a lenient out for Pfizer and could serve as a strong motivator to consummate the deal.

The Two-Tiered Approach. A number of the reviewed transactions used a two-tiered approach (or liability cap) with respect to remedies. This approach had also been used in a few private equity acquisitions during the 2005 to 2007 period.

Under the two-tiered approach, the buyer agrees to pay one RTF conditioned upon one set of triggers, and a second, higher RTF conditioned upon another set of broader triggers. For example, the RTF served as a liquidated damages payment from the buyer to the seller “if the sellers terminate the acquisition agreement because the shell buyer breached its obligation to close solely due to the failure to receive the contemplated debt financing.” If the buyer breached the acquisition agreement under circumstances not related to a financing failure, the

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153 Id.
154 See Aiello et al., supra note 85; Ginsberg et al, supra note 85, at 3 (referring to this approach as debt receipt failure fee approach). In addition to the capped approach, some transactions, used the no fee/capped damages approach. Under this version of the structure, instead of a contractually provided RTF coupled with a liability cap, the private equity sponsor’s guarantee covered damages up to a certain amount but in order for the seller to recover any money it would need “to prove actual damages suffered as a result” of breaches by the shell buyer of its obligations under the acquisition agreement. See, e.g., Wyndham International Inc., Definitive Proxy Statement (Schedule 14A), at 43-44 (August 11, 2005) (stating that the seller “cannot seek specific performance to require the parent or the merger sub to complete the Blackstone merger, and our exclusive remedy for the failure of the parent or the merger sub to complete the Blackstone merger is to seek damages up to the amount of the $275 million guarantee.”)
155 See, e.g., Neiman Marcus Group, Inc. Definitive Proxy Statement (Schedule 14A), at 67-68 (July 18, 2005). The Neiman Marcus acquisition agreement provided that an RTF of $140.3 million, approximately 2.8% of the equity value of the transaction, would be payable by the buyer to the seller in the event the closing did not occur due to the failure to receive debt financing proceeds (when other closing conditions were satisfied) or due to another breach of the acquisition agreement by the buyer. The agreement also provided that, in some circumstances, the $140.3 million RTF constituted complete and liquidated damages and therefore was the limit of the buyer’s liability. However, the buyer also could be liable for additional seller damages up to $500 million in the aggregate, approximately 9.8% of the equity value of the transaction, if the failure of the closing to occur did not result solely from the failure to obtain financing but from some other breach by the buyer. See Ginsberg et al., supra note 85, at 4.
156 Ginsberg et al., supra note 85, at 3.
buyer would be liable for generally higher damages or a higher RTF up to a capped amount.\textsuperscript{157} The buyer is allowed a walk right only upon payment of the higher RTF. In some agreements, the seller also retains a limited right to seek specific performance under this approach.

The Merck-Schering deal utilized this two-tiered structure, which has been dubbed the “new middle-of-the-road approach” in comparison to the pure option structure and the Pfizer-Wyeth structure.\textsuperscript{158} Like Pfizer, Merck would only have a pure walk right if there was a financing failure and Merck paid Schering-Plough the higher RTF of $2.5 billion.\textsuperscript{159} This RTF was approximately 6 percent of the deal’s $41 billion value and slightly less onerous than Pfizer’s 7.25 percent of deal value penalty.\textsuperscript{160} The conditions under which Merck can claim a financing failure are fairly broad, given that a financing failure occurs when “the proceeds of the Financing are not then available to [Merck] in full pursuant to the Commitment Letter.”\textsuperscript{161} If Merck were to exercise its financing out, Schering’s only recourse would be to terminate the deal and collect the RTF. That said, Merck still had a powerful incentive to consummate the agreement, considering that it would have suffered a $2.5 billion RTF if it arranged a financing failure.

The presence of a lower first tier termination fee also distinguishes the Merck-Schering deal from all of the prior deals discussed. Here, a lower RTF of $1.25 billion could be triggered if Merck failed to obtain its shareholders’ approval of the transaction or if it entered into a competing transaction with a third party. Under such circumstances, Schering could sue Merck for specific performance if financing had been obtained in full and all of the closing conditions

\textsuperscript{157} Aiello et al., \textit{supra} note 85.
\textsuperscript{159} See Agreement and Plan of Merger, Merck & Co., Inc., Schering-Plough Corporation, Blue, Inc., and Purple, Inc., §8.3 (Mar. 8, 2009).
\textsuperscript{161} Merck-Schering Agreement, \textit{supra} note 159, at §8.1(b)(ii).
had been fulfilled or waived, or it could collect the $1.25 billion and up to $150 million in reimbursed expenses.\footnote{162}{See Schering-Plough Corporation, Registration Statement (Form S-4) 115, 118 (May 20, 2009).}

In sum, parties in strategic deals used three different varieties of RTF structures during the 2008-mid 2009 period, many of which were primarily adapted from the private equity model of 2005-2007. This adaptation flies in the face of predictions that, in the wake of the broken deals of late 2007 and early 2008, RTF provisions would disappear from merger agreements as sellers pushed for greater certainty in acquisition agreements by negotiating for more onerous remedies, in particular specific performance.\footnote{163}{Vipal Monga, \textit{Seller Beware}, \textsc{The Deal} Magazine, Aug. 8, 2008, \textit{available} athttp://www.thedeal.com/newsweekly/features/seller-beware.php.}

\textbf{III. Assessing the Endurance and Transformation of Reverse Termination Fees}

As demonstrated by the empirical study set forth in Part II, RTFs are on the rise in strategic transactions. The deals of 2008-mid 2009 were significant not only because of the number of deals where RTF provisions were employed, but also because of the license that buyers were given to abandon the deal. Many deals in the 2008-mid 2009 period recognized the uncertainty of the credit markets and buyers contracted accordingly for walk rights upon a financing failure. In other deals, the buyers were able to use the private equity model to obtain broad walk-away rights with their exposure to damages limited to the RTF.

This section examines why strategic buyers have jumped at the opportunity to include RTF provisions in their acquisition agreements. Given the traditional focus by sellers on certainty of closing, it is somewhat surprising to see a rise in RTFs. However, there are a number of reasons why sellers in strategic deals have acceded to agreements with RTFs. Section A explains why
RTFs are increasingly being used in strategic acquisitions. Section B addresses some of the problems connected with the RTF model.

A. Explaining the Transformation of Reverse Termination Fees in Strategic Deals

It is hard to categorize the motivations of buyers and sellers in strategic deals using RTFs, in part because of the variety of structures that are being used, and in part because many of these transactions occurred during a period of extreme economic uncertainty. However, a few broad themes do emerge from a review of the acquisition agreements in which RTF provisions have been used and from an understanding of the contexts in which these agreements were made.

1. The Role of Economic & Financing Uncertainty

While there were a number of motivations for strategic buyers to bargain for RTFs in the 2008-mid 2009, similar to private equity firms, strategic buyers have advocated for RTFs in order to address uncertainty of financing in the marketplace, as well as to mitigate risks that may arise in a difficult economic environment. First, buyers could limit their liability to the amount of the fee in the event of deal breakdowns outside of their control, if, for example, financing became unavailable. Second, a buyer would still be able to escape paying the fee in the event that it could reasonably argue that the seller had suffered a MAC or had failed to comply with its obligations under the merger agreement. Third, buyers could use the RTF structure as an after-signing option payment if they then determined to walk away from the transaction in the event of further economic deterioration. That sellers are agreeing to RTFs despite the economic meltdown and pervasive uncertainty in the marketplace suggests that “sellers acknowledge the difficulty of the credit market.”164

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164 Id.
In 2008, given the financial crisis, financing for any buyer, whether strategic or private equity, was uncertain. While “the availability of financing was rarely an issue for strategic [buyers] prior to the debt market meltdown,” in an era of tight credit markets, there is less certainty that strategic buyers will be able to obtain loans to complete their acquisitions on favorable terms. Thus, in an era with greater risk to strategic buyers that financing will be unavailable, it thus seems rational for buyers in transactions with a financing component to insist on an RTF structure without any provision for specific performance.

The problem of the availability of financing is compounded by the terms of such financing. Stricter lending standards have caused lenders to treat strategic acquirers like private equity buyers, such that “even highly-rated borrowers are facing historically high margins and stricter terms, including pricing structures, covenants and conditionality typically associated with [LBOs] rather than strategic mergers by investment grade companies.” It appears that the market conditions that have forced lenders to equate strategic buyers with private equity buyers have similarly forced strategic buyers to structure their deals like private equity acquisitions. A strategic buyer that negotiates for an RTF therefore effectively requests that the seller assume some of the risks that the deal might fall through due to the uncertain economic climate and the harsher borrowing terms that it undertakes for the transaction.

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165 Avram Davis, (Reverse) Breaking Up is Easy To Do Long a Mainstay in LBOs, reverse breakup fees increasingly find their way into corporate deals, INVESTMENT DEALER’S DIGEST, Mar. 2, 2009. A survey of failed transactions in 2008 appears to reinforce that buyers were rational in concerns about the risk that financing would be unavailable. See Gibson, Dunn & Crutcher, Deal-Breakers, May 18, 2009 available at http://www.gibsondunn.com/Publications/Pages/Deal-Breakers.aspx (Stating that “According to Thomson Reuters’ data, 70 U.S. deals were “withdrawn” in 2008 (including 11 that were announced in 2008 but cratered in early 2009). Of these 70 reported deals that came apart after being agreed to and announced, . . . The largest single factor was the buyer's inability to obtain financing. In most of these deals, the buyer lacked a financing "out," was subject to a "reverse termination fee" provision and ultimately paid an amount that matched such provision. In the few cases in which a financing "out" existed, it functioned as intended, and the buyer escaped the transaction without penalty”).

As had been earlier noted by Chancellor Strine in the In re Topps decision, there had been a long-standing disparity in the use of financing outs and RTFs to address financing risks in private equity deals and the assumption of risk by buyers in strategic deals. While private equity acquisition provided an express out for buyers in the event that financing fell through, strategic transactions “historically . . . were structured without a financing condition and with an express provision entitling both parties to specific performance.”\footnote{Finley, supra note 96, at 2.} In describing this disparity Chancellor Strine stated in the In re Topps decision:

Apparently, financial buyers argue with a straight face that they should, because of reputational factors, be considered as presenting a lower risk of consummation for lack of financing than strategic buyers. Thus, in the past, financial buyers always argued for a financing out. Now, they say that they will agree to no out but only if their liability is capped at the amount of a reverse break-up fee. Meanwhile, strategic buyers continue to be asked to accept full liability for damages caused if they fail to close, even if the reason for not closing is based on financing, not a risk unique to a strategic buyer. This is an interesting asymmetry, and the factors driving it seem to include both economically rational ones and ones that are less rational.\footnote{In re Topps, 926 A.2d at 72 n.11.}

The assumption of at least some of the financing risk by sellers in strategic deals in the 2008-mid 2009 period thus narrows the distinction between the structure of such deals and private equity deals.

2. The Increasing Leverage of Buyers
Strategic buyers have also been able to shift risks to sellers in part because they may be the only option that sellers currently have. In other words, sellers appear to be agreeing to RTFs because “it’s a function of deals happening where there are few other logical buyers.” The dearth of buyers may be attributed to the sidelining of private equity buyers, or, such as in Mars’ $23 billion acquisition of Wrigley, the absence of other buyers large enough to acquire the seller.

There is some support that strategic buyers have actually replaced private equity buyers in the mergers and acquisition marketplace. The credit crunch has significantly curtailed availability of financing for private equity buyers. The lack of availability has reduced competition for transactions. In addition, while private equity firms are suffering from the availability of financing, “corporate buyers have the cash and profitability to do deals.” Essentially, as private equity firms have scaled back their purchases, “strategic players [have stepped] into the void, buoyed by their voluminous cash holdings and unhindered by competing private equity firms.”

The downturn in the economy coupled with a lack of competition from private equity buyers has also meant that “valuation multiples are now more reasonable, making [strategic] transactions more attractive and providing corporations with greater room to create value.” A buyer’s bargaining leverage is heightened in light of the economic meltdown. As a result of economic conditions and a lack of adequate financing, “sellers can no longer expect multiple

169 Id.
170 Id.
172 Id.
173 Id., at 1.
175 Gell, supra note 42 at 9.
bidder auctions, limited closing conditions and limited post-closing exposure. Rather, buyers are now in the driver's seat and have been using their advantage to strike favorable deals.”

While RTFs were less common in the 2003-2004 period when sellers had better bargaining leverage, “with the uncertainties in the credit markets and the overall business landscape, buyers are motivated to mitigate their risk as much as possible.”

Thus, “[b]uyers are seeking maximum flexibility and are negotiating acquisition agreements with favorable terms and conditions to ensure that, ultimately, they are not stuck in a bad deal.” Moreover, buyers “who bring cash to the table will have all the leverage in deal negotiations.”

According to one commentator, “none of the potential buyers of [a] company would sign without the conditional put.” These circumstances suggest that RTFs may persist. Strategic buyers may use this shift in structure to continually request RTFs “to provide an escape hatch if the condition of the overall market or the [seller] deteriorates.”

For some sellers the economic downturn has depressed the seller’s position such that they must sell the company. The Employers Holding-AmCOMP deal on Jan. 10, 2008 suggests such motivations for the sale of the company. AmCOMP is an insurance holding company headquartered in North Palm Beach, Fl. that provided workers' compensation insurance to small to mid-sized employers in 18 states. In 2007, it was the subject of a Florida Office of Insurance

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176 Michael J. Delaney, Role Reversal, DAILY DEAL, Nov. 28, 2008.
177 Id.
178 Id.
181 Id.
182 According to a recent Thomson Reuters study, bankruptcy-related mergers and acquisitions have “hit their highest level globally . . . and are set to keep rising as more companies are forced into distressed sales.” Brooke Masters & Julie MacIntosh, Bankruptcy-related M&A has “only just begun”, THE FINANCIAL TIMES, Apr. 12, 2009, available at http://www.ft.com/cms/s/0/05234d00-2788-11de-9b77-00144fabe5c0.html?dbk&nclick_check=1. It bears mention that the “target corporation in dire straits” argument is a limited one. Despite weak economic conditions, a vast majority of the strategic deals analyzed featured financially-healthy targets. These include the Altria-UST Inc. deal on Sept. 2, 2008, and the Pfizer-Wyeth deal on Jan. 25, 2009.
Regulation investigation that required AmCOMP and its subsidiaries to repay $8.4 million in excessive profits it realized over the course of 2003 to 2006.\textsuperscript{183} Further, AmCOMP appeared to be experiencing business problems, as indicated in their proxy disclosure that stated “the current weakness in the overall economy . . . was having an adverse effect on many of [AmCOMP’s] customers and resulting in declining payrolls and a corresponding reduction in the workers’ compensation premium revenue received from these customers.”\textsuperscript{184} Although there is no concrete evidence that AmCOMP was in a position where it had to sell itself, these problems collectively suggest that AmCOMP was in such a situation because Employer’s Holding successfully negotiated a lower purchase price eight months after the initial agreement.\textsuperscript{185} Because AmCOMP was in a poor bargaining position, it is possible that the RTF was easily acceded to in the interest of consummating the deal.

3. The Potential for Greater Certainty

Commentators have noted that one of reasons that sellers are amenable to RTFs is that with strategic buyers, the “risk of deals blowing up for financing reasons is relatively low.”\textsuperscript{186} To be

\textsuperscript{184} AmCOMP, Inc. Definitive Proxy Statement, at 24.
\textsuperscript{185} See AmCOMP, Inc., Form 8-K, Aug. 29, 2008.
\textsuperscript{186} Similarly, during the heyday of the private equity boom, many sellers viewed the RTF as a sort of insurance policy that could provide “protection for [selling] companies against the risk of non-consummation.” John Mark Zeberkiewicz & Blake Rohrbacher, The Price of Remorse: Paying Reverse Termination Fees to Excuse Performance, INSIGHTS, Oct. 2007, at 22. The Delaware chancery court in cases connected to private equity acquisitions also framed the fee as providing this type of protection. \textit{See In re Lear}, 926 A.2d at 108 (“Lear was also protected in the event that AREP breached the Merger Agreement’s terms by a reverse termination fee of $250 million. That fee would be triggered if AREP failed to satisfy the closing conditions in the Merger Agreement, was unable to secure financing for the $4.1 billion transaction, or otherwise breached the Agreement. But AREP’s liability to Lear was limited to its right to receive this fee.”); \textit{see also In re Topps}, 926 A.2d at 65 (framing the RTF as the seller’s only remedy for the buyer’s failure to close the transaction); Davidoff, \textit{supra} note 7, at 137 (“The reverse termination fee structure also provided more closing certainty than the structure it supplanted. In the pre-2005 structure, the structure was wholly optional. The acquiree entered into an agreement with thinly capitalized shell subsidiaries and the agreement itself contained a financing condition. If the subsidiaries refused to perform, or if financing otherwise failed, the acquiree was left with no compensation or recourse against the private equity firms
sure, the presence of a large fee could deter some buyers from exercising the option to walk away from the transaction, or could be demanded by buyers who refuse to even sign a deal without the fee. Nevertheless, as evidenced by the Brocade-Foundry transaction discussed below, this is not a particularly prudent reason for sellers to agree to RTF provisions.

Some sellers that have recognized the risks of an option-style RTF structure have entered into agreements where such fee is significantly higher than the STF in order to promote their desire for certainty of closing. For example, in the aforementioned acquisition of Wrigley by Mars, the acquisition agreement allowed Mars to walk away from the deal if closing “[had not] occurred on or before . . . the Termination Date,” or if Wrigley terminated the deal in the event of a representations and warranties breach by Mars, or “if all the conditions [to closing were satisfied] and [Mars] failed to consummate the merger.” Under the agreement, Wrigley’s sole remedy was the RTF and it was clearly prohibited from seeking specific performance of the contract. The Mars-Wrigley agreement is significant because the buyer’s broad walk-rights are mitigated by the $1 billion RTF, which is approximately 45 percent higher than the $690 million STF that Wrigley would have to pay if it abandoned the deal. The disparity between the two fees is indicative of Wrigley’s recognition that without a right to seek specific performance, its risk can only be mitigated by demanding a higher RTF. In fact, Wrigley’s proxy disclosure indicated that William Wrigley himself, the company’s executive chairman, negotiated the $1 billion

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187 See Marcus, Desperately Seeking Certainty, supra note 127 (“Mars said that it would only agree to the acquisition if the [seller] assented to a merger agreement that allowed Mars to walk for any reason on payment of a reverse breakup fee and explicitly barred specific performance.”).


189 Id., at § 8.1(d).
RTF.\textsuperscript{190} The proxy disclosure, however, does not indicate how the parties arrived at the specific number.

Not all sellers encountered Wrigley’s experience. Similar to the breakdown of private equity transactions in 2007, the use of the option-style RTF caused significant problems for some sellers. For example, Foundry Networks Inc. found itself in a precarious position when its $3 billion deal to be acquired by Brocade Communications almost fell apart because of the broad financing out and nominal RTF to which the parties had originally agreed. The agreement provided for an $85 million RTF triggered by a financing failure. Three months later, amid difficulty in obtaining $400 million in financing, Brocade considered abandoning the deal for its $85 million RTF.\textsuperscript{191} The problem arose firstly because “Financing Failure” as defined in the agreement was very broad—it was merely “a refusal or other failure, for any reason, on the part of any Person that has executed the Debt Commitment Letter . . . or on the part of any other Person obligated or expected at any time to provide a portion of the Debt Financing, to provide a portion of such Debt Financing.”\textsuperscript{192} There was no further restriction on the amount of debt financing that had to be refused, or the amount that Brocade would have to fail to obtain before the “Financing Failure” was met. Then, there was “a difference of interpretation between Bank of America and Morgan Stanley, the banks that agreed to finance this transaction, and Brocade on the interest rate provisions… of the $400 million in bridge financing,” upon which Brocade considered exercising its financing out.\textsuperscript{193} Additionally, as the RTF was the seller’s sole remedy, Foundry would have had no other recourse against Brocade.

\textsuperscript{190} See Wm. Wrigley Jr. Company, Preliminary Proxy Statement (Schedule 14A), at 22 (May 23, 2008).


\textsuperscript{192} Brocade-Foundry Agreement, \textit{supra} note 146, at Exhibit A, Certain Definitions, A-6.

Since the RTF amounted to only about 2.8 percent of the deal value, and the $85 million loss paled in comparison to the $400 million the buyer was unable to secure, Brocade was able to use the situation as a leveraging tool to renegotiate the purchase price. Indeed, “a simple cost of capital issue allowed Brocade to engineer the removal of its equity component in the deal and an additional $250 million cash price adjustment.” Brocade managed to reduce the deal value by $400 million, or essentially shifted the $400 million in financing to Foundry’s shareholders. For its part, Foundry was happy to “take the haircut and take a complete deal.”

4. The Conundrum of Specific Performance vs. Damages

As an initial matter, RTFs serve as a risk-mitigating device for sellers as well. RTFs provide sellers with some protection and recourse against the buyer if the deal is stopped or if it simply falls through. This is in part because while courts have granted specific performance in the past, it is not clear that they will continue to do so or that it is an appropriate remedy in an all-cash acquisition of a company. Furthermore, a 2005 decision in the Second Circuit in a suit arising out of a failed acquisition transaction, has led to considerable debate about the damages that would be recoverable in a breach of contract suit in such transactions.

The Second Circuit’s decision in Consolidated Edison v. Northeast Utilities has caused some sellers and their counsel to argue that providing for an RTF as liquidated damages could potentially provide greater compensation than the amount that the seller would be able to obtain in a breach of contract suit for money damages. After agreeing to buy the stock of electric utility company Northeast Utilities for the market price plus a 50% premium, Consolidated Edison decided that Northeast's business had undergone a MAC. It therefore refused to close and

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194 Id.
195 Id.
instead offered to negotiate a lower price. Both parties sued, with Northeast demanding the original premium for its stockholders.

The Second Circuit, applying New York law, held that Northeast and its shareholders were not entitled to recover the lost merger premium, over $1 billion, as damages after the buyer, Consolidated Edison, walked away from the transaction.196 Soon after the court’s decision, practitioners generally argued that the Second Circuit’s holding in Consolidated Edison meant that “absent clear contractual language to the contrary, neither the shareholders of a target company nor the target company itself (on behalf of its shareholders) [can] collect lost shareholder premium as damages for a breach of a merger agreement.”197

There is some disagreement, however, about whether the Second Circuit's holding in Consolidated Edison v. Northeast Utilities can be applied broadly to preclude the seller from ever recovering merger premium damages when a buyer fails to complete an acquisition. In a recent article, Ryan Thomas and Russell Stair argue that if such sweeping conclusions follow from the Second Circuit’s decision, then selling corporations “should be concerned that nearly every public merger transaction will be transformed, in substance, into an “option” deal allowing the buyer to walk away with little consequence . . [thus shifting] the balance of leverage in any renegotiation or settlement discussions firmly into the buyer’s camp.”198

196 Consol. Edison, Inc. v. Ne. Utils., 426 F.3d 524, 531 (2d Cir. 2005). Similar to most other public company acquisition agreements, the acquisition agreement at issue in Consolidated Edison did not provide the seller’s shareholder with third party beneficiary rights prior to closing. See Ryan D. Thomas & Russell E. Stair, Revisiting Consolidated Edison, 64 THE BUSINESS LAWYER 329, 330 (Feb. 2009).
197 Victor Lewkow & Neil Whoriskey, Left at the Altar—Creating Meaningful Remedies for Target Companies , M&A LAW, Oct. 2007, at 1, 1; see also Kevin Miller, The Con Ed Decision—One Year Later: Significant Implications for Public Company Mergers Appear Largely Ignored , M&A LAW , Oct. 2006, at 1, 1 (noting “the Second Circuit effectively held that, under New York law, an acquiror could not be held liable for target shareholders’ lost merger premium if the target shareholders were not intended third party beneficiaries entitled to such relief ”); But See Thomas & Stair, supra note 202, at 339-347.
198 Thomas & Stair, supra note 202, at 338.
Thomas and Stair contend that the Consolidated Edison decision can be limited to its facts, since the court’s reasoning relied on the exact wording of the particular agreement before the court, wording which few M&A agreements contain. More importantly, it is unclear whether the Delaware courts would in fact follow the Consolidated Edison rationale. In fact, in granting specific performance in *IBP v. Tyson*, “among the considerations that the court weighed in determining to award specific performance was the potential magnitude of any damages award, clearly evidencing that the court contemplated an expectancy-based damages award for the benefit of IBP and its shareholders.”  

In addition, as noted by Thomas and Stair, in a 2008 conference, Delaware Vice Chancellor Strine confirmed the assumption that “shareholder damages may be available in the event of a breach reflects a logical and practical understanding by the parties to merger agreements and provides for an orderly dispute resolution procedure.”

### B. The Potential Drawbacks of the Reverse Termination Fee Structure

Despite the potential flexibility and predictability that RTFs can provide for both sides in an acquisition transaction, the option-style structure that has emerged in strategic transactions, and that was commonly agreed upon in private equity transactions, could present significant problems for sellers. One of the most troubling developments in the rise of the RTF structure in private equity deals was the process by which the actual amount of the fee was set. Somewhat surprisingly, in a number of transactions, parties are continuing to set the RTF at amounts that

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199 Thomas & Stair, *supra* note 202, at 342; IBP, 789 A.2d at 83 (“In addition, the determination of a cash damages award will be very difficult in this case. And the amount of any award could be staggeringly large . No doubt the parties would haggle over huge valuation questions, which (Tyson no doubt would argue) must take into account the possibility of a further auction for IBP or other business developments. A damages award can, of course, be shaped; it simply will lack any pretense to precision. An award of specific performance will, I anticipate, entirely eliminate the need for a speculative determination of damages.”)

are identical or nearly identical to the STF. In transactions where the RTF is equal to the STF, the amount of the fee can significantly miscalculate the closing risks faced by sellers and their shareholders when agreeing to a contract with an option-style RTF provision. In addition, sellers have been consistently less than forthcoming with their shareholders and the public regarding the risks faced by the company when agreeing to this new allocation of closing risks.

In the wake of the financial crisis, the failure of the private equity structure has led to much criticism of RTFs. In fact, the frequency of RTFs in recent M&A deals even prompted a Wall Street M&A lawyer to remark, “It’s almost like a bad virus.” While the RTF provision was originally agreed to by sellers in private equity transactions primarily to promote certainty of closing of the contract, the provision failed to function as intended, in part because it was agreed to as the mirror of the STF. Thus, it is surprising to see that in a number of strategic transactions, parties are continuing to set the RTF at amounts that are identical or nearly identical to the STF.

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202 Manga, supra note 163.

203 As discussed above, in the vast majority of private equity acquisitions of public companies, the RTF was generally set at 3% of the deal value to make it mirror the STF in an acquisition agreement; essentially this was seen as a simple cost of doing business. See Davidoff, supra note 7, at 135-136 (finding that from 2005 to 2007, the average size of RTFs was 2.6 percent of transaction value); see also Christopher J. Bellini, Private Equity Deal Terms: The Song (Largely) Remains the Same, PRIVATE EQUITY FOCUS (Dorsey & Whitney LLP, Minneapolis, Minn.), June 2008, at 3, 4 (stating that “[t]he cap was typically a reverse termination fee that mirrored the break-up fee paid by the target to the buyer in the event that it terminated the merger agreement in favor of a superior competing offer”).

There is little rationale for linking the amount of the RTF with the amount of the STF. STFs are used as a deal protection device by the buyer in order to deter a third party bidder and agreed to by sellers in order to assure a deal with a preferred buyer. The size of STFs has been limited by fiduciary duty principles that require that directors maximize shareholder value in a change of control transaction and cannot enter into an agreement that deters a competing buyer or coerces the seller’s stockholders to accept the agreement. Unlike STFs, RTFs are not subject to the fiduciary duty concerns assessed by the Delaware courts. As demonstrated by the broken deals of 2007 and 2008 discussed below, “the in terrorem” effect of the reverse break-up fee had been mitigated by the practice of setting the reverse fee at the same amount as the STF.” In fact it seems that the only logical reason for setting the two fees at the same amount was “simplifying negotiations and a general sense of equity in treating buyer and seller alike.”

Furthermore, even in transactions where the RTF structure provided a pure option to the buyer to walk away by paying the fee, it is not clear whether the option was calculated according to any actual methodology. This suggests that some of the same mistakes made in the private equity era are being replicated in recent strategic deals. As noted by Professor Davidoff, the RTF option in private equity deals:

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205 See supra note 68 and accompanying text.
206 See In re Toys “R” Us, Inc. S’holder Litig, 811 A.2d 975, 999 (Del. Ch. 2005) (explaining that under Revlon and its progeny, once directors decide to sell corporation, they should do what any fiduciary should do when selling assets, which is maximize sales price for benefit of those to whom their allegiance is pledged; in corporate context, that means that directors must seek highest value deal that can be secured for stockholders regardless of whether it is in best interests of other corporate constituents.); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 923 (Del. 2003).
208 Id.
was not calculated according to any option pricing method. Nor did it appear to be
calculated by reference to the damage incurred by [the seller] in the event that it
was exercised by the private equity firm. The amount ultimately paid also did not
deter [buyers] from exercising the option in many instances. . . . ., and, in
hindsight, the amount appeared to undercompensate acquirees for the losses
incurred by the acquire company and its shareholders. Evidence of this came from
the post-termination share trading prices of acquirees against whom these
provisions were invoked. In the months after the exercise of this provision, the
share prices of these companies traded significantly below the pre-offer price.\textsuperscript{209}

From a deal risk allocation standpoint, it is clear that the RTF should be set at a higher level
than the STF given that in an option-style structure in particular, the seller is taking on
significantly more risk of deal failure in agreeing to a deal with an RTF provision than a buyer
takes with respect to having a deal jumped by a third party.\textsuperscript{210} For selling companies, an
acquisition transaction places immense pressure on the company’s business, including potential
loss of employees and customers and disruption of the company’s ordinary business operations,
along with a lengthy and time-consuming due diligence and negotiation process. This is not to
say that buyers do not also have incentives to complete the transaction, but that sellers may face
greater problems in the event of an announced transaction fails to close.\textsuperscript{211}

\textsuperscript{209} Davidoff, \textit{supra} note 7, at 135-36.
\textsuperscript{210} Of course, one could argue that the failure of boards to properly assess the risks of RTF provisions was
reasonable since private equity firms historically rarely terminated transactions. \textit{See} Davidoff, \textit{Breakup Fees}, \textit{supra}
note 126.
\textsuperscript{211} \textit{See} Davidoff, \textit{supra} note 7, at 140; Coates & Subramanian, \textit{supra} note 4, at 359; Sautter, \textit{supra} note 18, at 532.
Some scholars have argued that the “reputational damage” from not being able to close deals leads to view as a
“weak bidder” therefore increasing costs in future bidding wars and decreasing the likelihood of winning bids since
more bidders will enter bidding contests, \textit{See} Guhan Subramanian, \textit{The Drivers of Market Efficiency in Revlon
Transactions}, 28 J. CORP. L. 691, 701-02 (2003). On the other hand, with respect to large private equity firms, these
costs are likely to be low while the costs of an incorrect acquisition for a premier private equity firm like Blackstone
are far higher. In addition, private equity firms seem to operate on a “gentlemen’s agreement” to not jump each
An additional problem with the RTF structure in some acquisition agreements is not just that the fee has generally been improperly priced, but that the option-style structure provided a powerful tool for a buyer to walk away from a transaction or force renegotiation of the transaction at a significantly reduced price. Other provisions in the agreement exacerbate this problem, in particular, the MAC clause, which under most contracts would allow a buyer to claim that a MAC has occurred and generally not be obligated to even pay the fee.\(^{212}\) In a transaction with both an RTF and a MAC provision, the buyer has significant negotiating leverage—it could attempt to claim that a MAC has occurred so that it would not have to pay the fee, and even if the MAC claim fails, the buyer’s maximum liability would be capped at the RTF.\(^{213}\)

In addition to problems in some deals with the amount of the fee, as in the private equity era, sellers have been less than forthright with the shareholders in public disclosure about the role of the RTF. Sellers have touted that they had entered into a “definitive agreement” to be acquired, focusing on the value of the transaction and the premium to be received by the company’s stockholders, but rarely included much relevant information from which one could decipher whether the agreement included an option-style RTF.\(^{214}\) In fact, even experienced

\(^{212}\) Admittedly, buyers have rarely been successful in court at escaping their obligation to close a transaction by claiming that a MAC has occurred. \(^{213}\) See Nowicki, supra note 39, at 2 (stating that when the private equity buyers of Harman International Industries informed the company in September 2007 “that they were walking away from their agreement to acquire Harman for roughly $8 billion due to an unspecified material adverse change . . . Rather than engage in a legal battle over the MAC clause, the parties agreed to terminate the deal, and [the buyers] agreed to purchase $400 million in convertible debt from Harman in return for being released from the acquisition agreement’s $225 million reverse termination fee requirement.”). \(^{214}\) See, e.g., Reddy Ice Holdings, Inc., Current Report (Form 8-K) (July 2, 2007) (neither disclosure in item 1.01 or press release attached as Exhibit 99.1 mention RTF provision; although it is clear from reading Sections 8.3, 8.5 and 9.7 of the Agreement and Plan of Merger attached as Exhibit 2.1 that the RTF was seller’s sole remedy in event buyer did not close transaction). The transaction, valued at approximately $1.1 billion, was subsequently terminated
practitioners have noted that while acquisition agreements are presented to the seller’s shareholders and the public as a committed agreement by the buyer to complete the acquisition, one can determine if the agreement actually gives the buyer an option to pay the fee and walk away from the transaction without further liabilities by “only by carefully parsing the [reverse termination fee] and remedies provisions of the merger agreement . . . .”215

Some of the problems identified above have much to offer for judicial review of board decision-making and public company disclosure – topics that I will explore in a companion paper.

CONCLUSION

The analysis above suggests that a transformation is taking place in the allocation of deal risk in strategic transactions. It is not yet clear whether the acquisition agreements that will be entered into after this period will continue to reflect the increased use of RTFs to allocate deal risk. If the experience from deals in the 2005-2007 period is repeated, then one would expect that more deals will reflect the nuanced use of RTFs that one sees in some of the high-profile transactions such as the Pfizer-Wyeth transaction.216

The increasing complexity in the use of RTF provisions in some of the more sophisticated contracts of the 2008-mid 2009 period demonstrates that parties, as well as their counsel, had noted some – although not all – of the lessons of the failure of the private equity pure option by the private equity buyer in February 2008 after payment of the $21 million RTF. See Reddy Ice Holdings, Inc., Current Report (Form 8-K), § 1.02 (Feb. 1, 2008). Similarly Blackstone’s acquisition of PHH also included an RTF option that was ultimately exercised by the buyer to terminate the transaction, PHH Corp., Current Report (Form 8-K), § 1.01 (Jan. 7, 2008), although there had been little clear disclosure about the RTF at the time of announcement of the agreement. See PHH Corp., Current Report (Form 8-K) (March 14, 2007) (failing to mention RTF in either disclosure under Item 1.01 or press release attached as Exhibit 99.1).

215 Landau, Gietz and Aiello, supra note 102.
216 See King & Smith, supra note 9, at 40 (institutional theory suggests that “Mimicry of high-status organizations’ contractual elements soon leads to a diffusion of a new contractual form among organizations in an entire industry . . . . Thus, one implication of institutional theory is that adaptation of contracts over time may proceed in a fad-like fashion, with lower-status firms continually conforming to new standards set by higher-status firms.”).
In essence, these contracts appear to reflect evidence of at least some “population-level learning” from these failures. Of course, given the fact that a number of strategic deals continue to use the suboptimal provisions of the private equity RTF structure, it is clear that such learning is not yet widespread. Moreover, even the most sophisticated of contracts continue in the “persistent use of vague language even after the lessons from the broken deals of the past two years.”

Ultimately, the types of RTFs that have been employed by strategic deals in the wake of the economic crisis have been numerous and are still evolving. More changes to the existing structures will probably continue to manifest as parties negotiate with varying amounts of leverage and strategic considerations. While there continue to be manifestations of the same mistakes from private equity transactions in a number of strategic acquisition agreement, this Article’s empirical study and analysis of RTF structures demonstrates that acquisition agreements are beginning to reflect creativity and novel solutions to common deal risks.

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217 This supports the view of organizational learning theory which “suggests that we consider contracts as both inputs to learning processes and outcomes of learning. As inputs, contracts may assist organizations in developing incremental changes in their structure. As outcomes, contracts are routines that are learned through experience with relational contracting and that contribute to organizational inertia.” Smith & King, supra note 9, at 29.

218 Smith & King, supra note 9, at 32.

219 For a discussion of suboptimal provisions in contracts, see, e.g., Stephen J. Choi & G. Mitu Gulati, Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds, 53 EMORY L.J. 929, 937 (2004) (“Change not only takes time, but also comes in stages—as we describe it, there is first an interpretive shock, then a lengthy period of adjustment, and only then a big shift in terms.”).

220 Choi & Triantis, supra note 12, at 13.
APPENDIX A – METHODOLOGY

In order to obtain a large sample of strategic deals that were announced between January 1, 2003 and December 31, 2004; and January 1, 2008 and June 30, 2009, my research assistants and I reviewed all Form 8-K “current report” filings with the Securities and Exchange Commission for each of the periods that contained as exhibits contracts labeled under the term “merger” or “2.1”. A current report on Form 8-K must be filed by companies subject to the periodic reporting requirements of the Securities and Exchange Act of 1934 within four business days from the date when the company enters into a definitive material agreement, including a merger agreement. In general, the reporting firm includes the actual agreement as an exhibit to the Form 8-K. The agreements are therefore available on-line via the EDGAR system of the Securities and Exchange Commission (SEC).

For the 2003 to 2004 period, our results yielded a total of 1,027 filings on Form 8-K. We analyzed each such filing to determine whether it could be categorized as a business combination, including mergers, major asset acquisitions and stock transactions. The listings were reviewed for duplicates, amendments to previously-filed agreements, agreements not related to business combination transactions, such as a reincorporation, a recapitalization, an internal reorganization, going private transactions involving an existing majority stockholder.

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222 See Miller, supra note 2, at 2091; Additional Form 8-K Disclosure Requirements, supra note 296, § 1, Item 101 (“we encourage companies to file the exhibit with the Form 8-K when feasible, particularly when no confidential treatment is requested”). The company is required to file the agreement as an exhibit to its next periodic filing if it does not file the agreement as an exhibit to an 8-K. Id. The study conducted for this Article did not consider any merger agreements filed other than as exhibits to Forms 8-K.

223 Firms use the statutory merger form to accomplish non-business combination goals such as a recapitalization or a reincorporation in order to avoid class voting or to squeeze out a minority block of shareholders. See Dale A. Oesterle, THE LAW OF MERGERS AND ACQUISITIONS (3d ed. 2005) at 5, 84-85.
We also excluded transactions where the buyer was a financial buyer, such as a private equity firm or a specified purpose acquisition company, i.e. a newly formed company without any business operations that has been organized with the sole purpose of going public and using the proceeds of the public offering to acquire an existing operating business.\textsuperscript{224} We obtained a sample of 532 strategic transactions. Because reverse termination fees (RTF) have a variety of naming conventions, we reviewed the terms of each of the 532 agreements to determine whether the agreement included an RTF provision. We found that 90 of the 532 transactions, or approximately 16.9%, included RTF provisions.

For the 2008 to mid-2009 period, our results yielded a total of 603 filings on Form 8-K. We followed the same methodology described above to determine whether the filing could be categorized as a business combination, including mergers, major asset acquisitions and stock transactions. We obtained a sample of 291 strategic transactions. Following a review of these 291 agreements, we found that 76, or approximately 26.1%, included an RTF provision.

For each agreement, we examined the contractual triggers for payment of the RTF, the relationship between the amount of the STF and the RTF, whether the contract provided for monetary remedies in addition to the RTF, and whether, and under what circumstances, a specific performance remedy was available for the seller under the contract.