CERTAINTY & OPTIONALITY:
The Evolving Nature of Reverse Termination Fees in Allocating Deal Risk

I have seen and been involved in a lot of acquisitions where that big question is left unanswered.
- Darin Brumby

INTRODUCTION

Each year, thousands of buyers and sellers come together to ink merger or acquisition agreements. Often, however, there is the looming question of whether or not the deal will actually close. Given this uncertainty, buyers and sellers contemplate that the deal will fail to close and the merger or acquisition agreement will be terminated. Penalties for calling off the deal are built into an agreement through various deal protection devices, including reverse termination fees (RTF). This paper will demonstrate the evolving nature of RTFs as deal protection devices designed to allocate risk in merger and acquisition agreements.

Despite the growing salience of RTFs in merger and acquisition agreements over the past few years, there is a dearth of commentary from scholars and courts. In two recent empirical studies, Professors Elizabeth Nowicki and Afra Afsharipour document the growing and changing use of RTFs to better understand the allocation of risk between parties in merger and acquisition agreements. Part I of this paper will briefly overview the uncertainty surrounding closing and the rise of RTFs. Part II will outline Nowicki’s RTF findings. Part III will detail Afsharipour’s study surrounding the transforming nature of RTFs as methods of allocating deal risk. Finally, Part IV will comment on the conclusions posited by Nowicki and Afsharipour by studying RTFs in merger and acquisition agreements over the past three years, from 2010-2012. Evolving agreements over the years have become more prominent, strategic, and sophisticated in their allocation of risk. Parties especially continue to develop their use of RTFs, not only by increasingly including RTFs as a risk allocation provision in agreements, but also by altering the size, complexity, and relationship of RTFs compared to traditional deal protection devices. This more appropriately accounts for risks faced by sellers attributable to buyers.

PART I

Merger and acquisition transactions inherently include deal risk. Deal risk is comprised of the various factors that may delay or prevent the closing of an announced merger or acquisition agreement. When parties to a merger or acquisition agreement close a deal, the result often reaps financial rewards from the synergistic gain in value created by the combination of the entities or assets. Failure to close a deal, however, may carry serious consequences for both buyers and sellers, public and private alike. These consequences include loss of countless dollars spent on due diligence; loss of key management or employees; and disruption of supplier, customer, or other contractual relationships. For public companies, the closure question carries special importance given that there is usually a longer interim period between when the merger or acquisition agreement is signed and when the deal closes. Thus, a rejected seller may face substantial blowback from the marketplace, resulting in a plummeting stock price or a stigmatization preventing future deals.

There are several reasons a deal may fail to close. The parties may fail to gain necessary regulatory clearance from a federal or state agency, such as antitrust clearance from the
Department of Justice or the Federal Trade Commission, or approval from a state gaming commission. One party may fail to obtain needed shareholder approval. A seller may instead accept a proposal from a superior third-party bidder, or its board of directors may simply change its recommendation. A buyer may fail to obtain the necessary financing, or increasingly the acquiring entity simply suffers from buyer’s remorse. As a result of these exigent circumstances and the uncertainty surrounding a deal’s closure, parties explicitly consider the failure of the deal to close in drafting a merger or acquisition agreement by allocating, mitigating, or addressing that risk through various deal protection devices and remedies.

One such deal protection device used to allocate closure risk is termination fees. Standard termination fees (STF), or “break fees,” are long-recognized remedies contained in the overwhelming majority of merger agreements. STFs are generally cash payments payable by the seller to the buyer if the seller terminates the agreement prior to closing under certain specified circumstances. Courts have traditionally constrained STFs given directors’ fiduciary duty principles, especially those surrounding the requirement to maximize shareholder value.

Although STFs are constrained, the prominence with which they appear in merger agreements suggests a conscious recognition by sophisticated parties that termination fees generate more certainty in managing deal risk than other traditional methods such as specific performance, or an award of damages. Specifically, vast uncertainty is created by entrusting the outcome of a failed deal, including the assessment of damages, to a judge or jury which produce highly varied results that may be inappropriately low or high in the parties’ individual views.

Historically, STFs are paid by the seller to the buyer; more recently, sellers have also begun demanding the payment of termination fees—RTFs—to allocate for risk that the deal may not close due to some action of the buyer instead of the seller. RTFs are cash payments payable by the buyer to the seller if the buyer fails to consummate the transaction or terminates the merger or acquisition agreement for certain specified circumstances. Although RTFs have been used as a deal protection device since the mid-1980s, they did not grow in popularity until the mid-2000s. Indeed, only 13% of all large deals had RTFs in 1998.

The true advent of RTFs in merger agreements corresponded with the growth of private-equity buyers in the deal marketplace from 2005-2007. Private equity firms and other financial buyers seek to grow, improve and sell an acquired entity at a substantial gain using leveraged debt financing from one or more lenders in a leveraged buyout. Often times, acquired companies are sold off in pieces worth greater than the whole. During the private equity boom in the M&A marketplace from 2005-2007, private equity financial buyers sought to include RTFs in merger agreements to allow the firm to walk away from the deal in the event that the financing fell through or its terms changed. Instead, the buyer would pay a certain percentage of the purchase price as a cash fee to terminate the agreement.

Sellers, viewed RTFs as a favorable remedy, which provided more certainty in outcome and compensation than having to seek specific performance or damages against a poorly funded “shell” company newly set up by the private equity buyer as the main party to the agreement. Thus, RTFs began to figure prominently as deal protection devices as sellers found themselves engaged in increasingly large transactions with increasingly more financially leveraged buyers.

Later, as credit markets tightened during the financial crisis, financial buyers continued to
Lisa Peterson  
Mergers & Acquisitions, Spring 2013

use RTFs in merger agreements to provide increased optionality amid rampant marketplace uncertainty. In addition to using RTFs to terminate agreements due to lack of financing, buyers began using the fees to completely walk away from a deal simply because they changed their mind or the deal did not appear to be as fruitful as once thought.

Noting this success, strategic buyers, which use cash or stock to create operating synergies by combining companies in the same or complementing industries, also began incorporating RTFs in merger agreements. Besides protecting against financing failure and buyer’s remorse, strategic deals are most likely to use RTFs to shift other risks hindering the deal’s closing to the buyer, such as regulatory approval failure, an injunction prohibiting the deal, or other duties embodied in the representations, warranties, and covenants. This encourages the buyer to use its best efforts to fulfill these requirements, to avoid bearing the burden of the RTF penalty. Thus, RTFs have emerged as a common, yet innovative deal protection device, giving buyers the flexibility to walk away from a deal while at the same time incentivizing a buyer to make good on the agreement and close the deal lest it make a huge payout to the seller to compensate it for lost opportunity, cost, and reputational damage.

PART II: NOWICKI’S REVERSE TERMINATION FEE STUDY

Nowicki completed the first comprehensive empirical study of RTFs, studying 2,024 merger and acquisition agreements from the Securities Data Corporation from January 1, 1997 to January 1, 2008. She included agreements only with an announced value of over $500 million. The study was limited to agreements defined as a merger that were completed or withdrawn by the study’s close. The average deal size of the observation set was $3838.57 million.

Ultimately, the study found an increased prevalence of RTFs in merger agreements, up nearly 10% from the prior 1998 study. Nowicki found that between 1997 and 2008 22.88%—just under one-quarter—of all merger agreements included an RTF. Notably, the average deal size of agreements with an RTF—$6222.39 million—was significantly higher than that of the entire observation set. The study did not comment on the relationship between the RTF and the STF even though nearly 94% of the agreements included both provisions.

Given this conclusion, Nowicki suggested further research to explore exactly how parties to an agreement were allocating deal risk. Nowicki’s data observations can be explained in two different ways—one which more favorably allocates deal risk faced by the buyer, and the other which more favorably allocates deal risk faced by the seller. As deal size increased and more was at risk monetarily, the presence of an RTF was more likely. Buyers would be more likely to insist on the inclusion of an RTF as an escape hatch, that is to have the option to refuse to close the deal down the road for the payment of a set fee which limits buyer damages. Thus, buyers, are allocating for the risk of a future change in circumstances and using RTFs to provide maximum flexibility in deciding the future of the deal. Nowicki questioned whether this RTF usage was value-creating for sellers at all.

On the other hand, sellers are more likely to insist on the inclusion of RTFs as insurance, that is, as a penalty against buyers to ensure the buyer has incentive to make good on an agreement to buy a sizeable target. Thus, a seller includes RTFs to allocate for the risk that it will suffer damages and be left empty-handed should the deal not close. Understanding which explanation drives the inclusion of RTFs is crucial because it will allow a seller to make a more
prudent decision as to whether it should insist a potential buyer be subject to an RTF.

PART III: AFSHARIPOUR’S REVERSE TERMINATION FEE STUDY

The second study of RTF provisions in merger agreements, conducted by Afsharipour, examined only public deals with strategic buyers announced over two periods: January 1, 2003-December 31, 2004 and January 1, 2008-June 30, 2009. The data was observed from all Form 8-K current report filings with the Securities and Exchange Commission’s EDGAR database that had exhibit contracts labeled as “mergers.”\(^1\) There was no minimum deal value requirement.

For the 2003-2004 period, Afsharipour’s results yielded 1,027 Form 8-K filings, of which 542, or 53%, were strategic transactions. Of the strategic transactions, 18.8% contained an RTF. During this period, the mergers observed allocated risks similar to the risk allocation structure of STFs. In addition to the structure, the price of the RTFs was set equal to the STF in a substantial majority of deals, again highlighting the initial dependence on STFs.

Afsharipour concluded this risk allocation structuring in the RTFs was inappropriate as it did not properly consider the unique risks faced by sellers, nor adequately compensate sellers for those risks. Notably, the only deals where the RTF was priced markedly higher than the STF were transactions in which the deal gave the buyer significant flexibility to walk away from the deal. This showed that parties were slowly learning to allocate risk differently by trying to price the buyer’s option to walk away and fail to close the deal.

In 2007-2008, Afsharipour yielded 603 Form 8-K filings, of which 292, or 48.4% were strategic transactions. Of the 2007-2008 strategic transactions, 25.7% contained an RTF. This represented a significant increase (6.9 points) in the percentage of strategic deals containing an RTF compared to the infrequent use of the deal protection device before the private equity boom.

Afsharipour noted the increasing creativity and complexity of RTF structuring in the 2007-2008 period, including the advent of two-tiered fee provisions to better price the risks faced by the seller in the face of increased optionality. This included new and different risks such as giving the buyer the option to terminate the deal for any reason. Notably, the number of deals with RTFs set equal to the STFs dropped significantly. Despite this drop, over two-thirds of deals still set the two provisions equal. Only one-fifth of the deals included an RTF set higher than the STF, usually to allocate for risks such as regulatory approval failure, financing failure, or failure to consummate the deal for any reason.

Afsharipour’s study demonstrated that RTFs were on the rise between the 2003-2004 and 2007-2008 periods. While strategic buyers borrowed from the repertoire of financial buyers by using RTFs as risk allocation tools, they also changed the ways they were used. This resulted in more complex allocation of risk between buyers and sellers in the 2007-2008 period.

However, given that the 2007-2008 period followed the private equity boom, Afsharipour questioned whether the increased use of RTFs would continue in later periods once the deal landscape returned to normal and buyers lost some of their increased negotiating flexibility. If so,\(^1\) Afsharipour reviewed observations to ensure a deal could be categorized as a major business transaction, such as a merger, major asset acquisition, or stock transaction. If not, it was excluded. The study also excluded duplicates, amendments to previous filings, and going private transactions involving an existing majority stockholder.
a primary issue of concern with pricing remained: whether RTFs would continue to misallocate risks by setting the price equal to the STF. Specifically, parties to a merger agreement should be more cognizant that the RTF is not constrained by the fiduciary limits binding the STF.

PART IV: ANALYSIS OF NOWICKI & AFSHARIPOUR’S FINDINGS

To assess Nowicki and Afsharipour’s conclusions regarding RTFs and evaluate the changing nature of deal risk allocation, this author designed an empirical study to measure RTFs in merger agreements over the past three years. The 2010-2012 time period is of specific interest since it represents a period of economic recovery and increased M&A activity with more equal negotiating power. Thus, it is important to analyze how parties have continued to allocate deal risk in the aftermath of the financial crisis and whether prior trends regarding RTF use still exist.

The study examined public and private merger and acquisition agreements announced between January 1, 2010 and December 31, 2012 with a value of $100 million or greater and included both strategic and financial buyers. Data was obtained from the Practical Law Company’s “What’s Market” database.

The results demonstrated the use of RTFs as risk allocation tools in merger agreements is still evolving. The data produced 937 total observations with an average deal size of $1400.92 million over the 2010-2012 period. Of the total observations, 303, or 32.2%, of the merger agreements included a traditional RTF. These RTF-inclusive agreements had an average deal size of $2068.82 million. Thus, there was a substantial rise in total number of agreements including RTFs as deal protection devices from Nowicki’s 1997-2008 study. Again, agreements with a higher deal price and more at stake were more likely to include an RTF.

The data was also broken out into subsets based on the type of agreement (public or private) and the type of buyer (strategic or financial) to highlight subset trends and differences.

A. Public v. Private Transactions

Of the 937 total observations, 482 represented public merger or acquisition transactions with an average deal size of $1957.79 million. Of the public merger agreements, 207 agreements, or 43%, contained an RTF provision. The average deal size for RTF-inclusive public agreements was $2310.1 million. Not only are public agreements with a higher deal price more likely to contain an RTF, but there also was a high prevalence of RTFs generally.

Notably, 46, or 22.22% of public agreement RTF provisions were tiered fee provisions. While most of the tiered-fee provisions were two-tiered provisions (42), three three-tiered provisions, and one four-tiered provision were also present. Not only did the findings indicate a significant increase in the prevalence of tiered-fee provisions used from Afsharipour’s study, but they also demonstrate the enhanced sophistication and evolving complexity of RTFs as deal protection devices. While Afsharipour’s study only noted the presence of two-tiered RTFs, modern day deals are more likely to have multiple-tier RTFs to better price the individual risks

---

2 Like Afsharipour’s study, data was limited to those agreements constituting major business transactions like a merger, major asset acquisition, or stock transaction. Non-major business transactions, duplicates, amendments to prior filings, and going private transactions with an existing majority stockholder were excluded.

3 The total observation set data included tiered-fee RTF provision observations. It excluded the alternative RTF provision observations found in the private agreements discussed infra in Part IV:A.
faced by sellers or the options granted to buyers. No longer are risks lumped into one or two fee-pricing mechanisms, but rather fees are individually tailored to suit the deal’s needs.

The average RTF of all the public agreements, including the tiered-fee option provisions, was 4.4%. Additionally, in a marked reversal of trend, the substantial majority—nearly two-thirds—of the RTFs were set at rates higher than the STF. On average, the RTF was set 137.1% higher than the STF. Only 28%, or 58, of the public agreements, were set equal to the STF. In 11, or 5.3%, of the public merger observations, the RTF was actually set lower than the STF fee by an average rate of 44.12%. Thus, RTFs as a percentage of the deal price are shifting away from the judicially accepted mean for that of an STF. This represents a departure from Afsharipour’s findings that the RTF typically equals the STF. Now, a significant number of RTFs are set higher than the STFs.

Next, the private transactions. Of the 937 total observations, 455 represented private acquisition agreements. The average deal size of the private agreements was $844.05 million. Of the private agreements, 96, or 21.1%, included a traditional RTF provision. The average deal size of the private agreements with an RTF was $1827.54 million. Once again, RTFs were more likely in those deals with more at stake finically.

Only 10 of the 96 RTF-inclusive private agreements, or 10.4%, included a tiered-fee provision. While the majority of these observations, 6, were two-tiered fee provisions, there were also two three-tier, two four-tier, and even one five-tier RTF provisions observed. Similar to the public agreements, there is an growing usage of tiered fee provisions in private agreements. The evolving structure and number of tiers used again highlights the enhanced innovation used by parties to transform RTFs to more appropriate price the various risks faced by a seller.

The average RTF of all private agreements was 5.1%. Interestingly, when comparing the RTFs to the STFs in the private agreements, the substantial majority of agreements with an RTF, 67 or nearly 70%, were included in agreements with no STF. Thus, in these agreements, the mere inclusion of an RTF next to a completely non-existent STF, created immediate sell-side risk allocation favorability. Sellers were better off by including the provision as a mechanism to allocate and price risk they faced in relation to the buyers. In 13, or 13.5%, of the private agreement observations, the RTF was set equal to the STF. Only 4 of the agreements had an RTF priced higher than a directly comparable STF. On average, these provisions were priced 56.1% higher than the STF. Only one private agreement had an RTF priced lower than the STF. The rate of change was 33% lower.

Additionally, an interesting trend emerged in the private agreements. Nearly 5%, or 20 of the 455 total private observations, included a provision requiring the buyer to forfeit its deposit on the transaction to the seller if certain specified triggers occurred. The triggers requiring a forfeited deposit were very similar to those triggering an RTF. The average deposit forfeited was 5.4% of the deal’s purchase price. Further, two deposit forfeiture provisions were two-tiered options with different percentage deposits forfeited depending on the trigger satisfied.

---

4 If the options included in the tiered-fee provisions were excluded from the public merger agreement data, the total number of public merger agreements with an RTF observed was 161. The average size of the RTF was 4.7%.

5 If the options included in the tiered-fee provisions were excluded from the private merger agreement data, the total number of public merger agreements with an RTF observed was 86. The average size of the RTF was 5.4%.
It is clear parties are modeling these “alternative RTF” provisions off the regular RTF provisions, considering the similarity in the percentage deposit forfeited compared to the RTF, the resemblance of the specified triggers, and the migration of tiered-fee optionality. This emerging trend demonstrates increased sell-side value creation written into agreements. Sellers are continuing to innovate by negotiating for more certainty in allocating deal risk. By adopting provisions resembling RTFs in size, triggers, and optionality but requiring forfeiture of a deposit rather than payment of a fee, sellers are negotiating for a quicker, more guaranteed receipt of funds to cover expenses and damages incurred in a terminated agreement. When the deal fails to close, the seller can immediately recoup funds which have already been set aside, rather than having to wait to collect payment from a buyer, or worse, face a buyer attempting to argue it does not have to pay the RTF because the breach resulted in a material adverse change.

B. Financial v. Strategic Buyers

The data also demonstrated interesting difference between strategic and financial buyers over the 2010-2012 period. Of the 937 total observations, 791 were strategic transactions and 146 were financial transactions. Looking at the strategic transactions, of the 791 observations, 204 or 26% included an RTF provision. Public, strategic transactions were more likely to have a higher rate of RTF inclusion than private, strategic transactions—33% to 19%, respectively. In addition to the overall prevalence of RTFs in public agreements, the rise of RTFs is documented by the 13.2% and 6.3% increase in use in public strategic transactions from Afsharipour’s directly comparable 2003--2004 and 2007-2008 studies, respectively.

Examining the financial transactions, of the 146 observations, 99, or 68%, included an RTF. Public, financial transactions were also more likely to include an RTF than private, financial transactions—75% to 44%, respectively.

C. Conclusion

In the improved economic conditions following the Great Recession, RTFs have proven to be prominent and increasingly sophisticated deal protection devices. While Nowicki and Afsharipour documented the rise of RTFs, each expressed concern as to whether RTFs would survive as useful risk allocation tools. RTFs have emerged as a sustainable risk allocation device. The 2010-2012 study shows significant overall growth in the use of RTFs in deal agreements. It is no surprise that RTFs have maintained a greater presence among both public transactions and financial buyers. More notably the rate of RTF usage in strategic transactions, particularly public, strategic transactions continues to rise. Though initially strategic buyers borrowed RTFs from financial buyers’ merger agreements, their sustained use in strategic transactions demonstrates that RTFs have continued to evolve as a unique and innovative risk allocation mechanism for sellers. While RTFs clearly provide buyers with welcome optionality in many deals, the 2010-2012 study validates RTFs as value-creating tools for sellers due to both their use in providing more certain, individually tailored risk remedies and as incentive mechanisms to close the deal.

Not only are parties using RTFs more, but they are using RTFs to allocate risk smarter and more strategically. In the 2010-2012 period, there was a substantial increase not only in the presence of tiered-RTF provisions, but also in the number and complexity of the tiers. Thus, parties are continuing to innovate and learning to allocate risk more effectively by pricing various options and risks individually. For example, a buyer may pay one fee for failure to close
the deal for breach of representations, warranties, or covenants, a higher fee for a financing failure, an even higher fee for regulatory approval failure, and the highest fee for the right to walk away from the deal. This more strategically allocates for and prices individual sell-side risks created by buy-side optionality and deal closure requirements. It also shows sellers are less likely to take on any of the risks that the deal will fail to close, such as regulatory failure, and instead are assigning that risk to the buyer through the use of RTFs as an insurance mechanism.

Lastly, the 2010-2012 study of RTFs demonstrates a greater awareness of the pricing issues raised by Afsharipour. A substantial majority—two-thirds—of public merger agreements contained an RTF set higher than the STF. These RTFs were on average 137% greater than the STF counterpart. Additionally, most private agreements with an RTF did not have an STF, showing sellers’ willingness to negotiate for the deal protection device when faced with appropriate risks from the buy-side of the transactions. This enhanced pricing shows that, when negotiating an RTF, parties are less dependent on the STF; rather, parties are more appropriately pricing RTFs for optionality and risks faced from the buy-side. This implicitly supports an increased awareness by parties that the RTF is not constrained by the fiduciary duties limiting STFs. Therefore, by using sophisticated and innovative RTFs, sellers are increasingly shifting risks that hinder the consummation of the deal to the buyer and learning to price those risks to appropriately allocate for the fallout. Ultimately, this builds more certainty into deals.