HERBERT SMITH FREEHILLS

RECENT DEVELOPMENTS WITH REVERSE BREAK FEES

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Legal Briefings – By **Rod Levy**

IN BRIEF

- Halliburton Co.'s payment of a US$3.5 billion reverse break fee highlights significant differences between Australian and US practice.
- Australian acquisition agreements could allocate and price deal-risk more accurately when reverse break fees are negotiated.
- In agreeing reverse break fees, boards of bidders must ensure they comply with their directors' duties and targets will need to consider enforceability issues.

SUMMARY

In May 2016, Halliburton Co. paid an eye-watering US$3.5 billion reverse break fee to acquisition target, Baker Hughes, after failing to secure anti-trust approval. The fee represented 10% of Baker Hughes' equity value.

The Halliburton situation and US market practice highlights a sophisticated approach to reverse break fees. Australian acquisition agreements could adopt some of this practice to better allocate and price deal-risk.

HALLIBURTON/BAKER HUGHES REVERSE BREAK FEE

A reverse break fee is a fee payable by a bidder to a target if an M&A transaction does not proceed, usually due to an event within the control of the bidder.

Halliburton and Baker Hughes agreed the following ‘failed-deal’ fee structure:

- US$3.5 billion payable by Halliburton if anti-trust approval was not obtained by 30 April 2016,
- US$1.5 billion payable by Halliburton if Halliburton failed to secure shareholder approval or the Halliburton Board changed its recommendation, and
- US$1 billion payable by Baker Hughes if there was a successful competing proposal or the Baker Hughes Board changed its recommendation.

The deal was terminated by the parties on 1 May 2016, after the US Department of Justice took action to block the merger for anti-trust reasons. Halliburton paid a US$3.5 billion reverse break fee to Baker Hughes.

AUSTRALIAN VS US MARKET PRACTICE

Australian practice

We reviewed 25 Australian public M&A deals announced since 1 January 2015 with a value above $50 million. We found:

- 14 had a reverse break fee,
- in 13 deals, the reverse break fee was the same size as the target’s break fee (the largest being 1% of target equity value),
- in 10 deals, a material breach by the bidder was only trigger for the reverse break fee becoming payable, and

- 1 deal contained a reverse break fee linked to failure of a regulatory approval condition, which was a multiple of the fee for the bidder's material breach. This was Iron Mountain's acquisition of Recall, a US bidder acquiring an Australian target that has a predominantly US-focussed business.

US market practice

Thomson Reuters reviewed US public deals in 2015 with a value above US$1 billion, finding:

- 33 deals had a reverse break fee,
- the average size of the reverse break fee was 6% of the target's equity value, while the largest was 12% of the target's equity value, and
- 19 were at least double the size of the target's corresponding break fee.

In recent years, the US market has produced innovative reverse break fee structures, including:

- Siemens AG's acquisition of Dresser-Rand Group in 2014 included additional consideration of 55 cents a share per month beyond an agreed implementation date; and
- AT&T Inc's acquisition of T-Mobile U.S. in 2011 included a reverse break fee for failure of an anti-trust approval condition comprising of US$3 billion, transfer of a radio spectrum to T-Mobile and granting a more favourable network sharing agreement.

ISSUES IN AGREEING A US$3.5 BILLION DOLLAR REVERSE BREAK FEE

There are obvious issues for the bidder and the target in agreeing to a large fee.

Bidders: Complying with directors' duties

Agreeing to pay a break fee on certain contingencies requires the directors of the bidder to first assess the risk that the contingency will arise and then assess the benefit to the company from the overall transaction in light of that risk. If the risk of the fee becoming payable is very high, it may be reckless to agree to the fee.

In the Halliburton situation, anti-trust risk was clear. The deal would have merged the world's second and third largest oil services companies. It is impossible to gauge how Halliburton's directors considered this risk. However, we presume that they must have received legal advice that there were reasonable prospects of gaining anti-trust approval and that they considered that relying on that advice was reasonable. One might imagine that, where the reverse break fee is so large, the advice would need to express a high degree of confidence that the approval would be forthcoming.

Targets: Unenforceability of penalties

For targets, a large reverse break fee may be susceptible to challenge by the bidder. Under the law of penalties, an agreed amount of damages payable on contract failure will be unenforceable if it does not represent a 'genuine pre-estimate' of the loss that may be suffered. Australian and US penalty laws are consistent, though largely untested as they apply to break fees.

Would the US$3.5 billion fee paid by Halliburton have been characterised as a penalty by Australian courts?

1. **Failure of a condition vs breach of contract**: The fact that the fee was paid for a condition failure, not a breach of contract, does not preclude the Australian law of penalties from applying. The High Court confirmed in *Andrews v ANZ Bank* that the penalties doctrine can apply beyond breach of contract circumstances, including pre-agreed damages for failure to satisfy a condition.

2. **Genuine pre-estimate of loss:**

- Transaction costs: It is unlikely that Baker Hughes, as the target company, suffered US$3.5 billion in transaction costs from the failed deal. Baker Hughes conducted a buy-back and debt repayment with the proceeds of the reverse break fee, which suggests the payment went well beyond mere cost recovery.
- Unquantifiable loss: Baker Hughes would have potentially suffered the diversion of

management attention, loss of customers and employees and loss of opportunities.

- The courts will be reluctant to interfere with pre-agreed estimates of loss where the loss is difficult to quantify, such as management distraction and loss of opportunity.
- The fact the fee was negotiated by sophisticated parties that benefited from experienced advisers would also reduce the likelihood of judicial intervention.

3. **Loss of offer premium not relevant**: Compensation for shareholders' loss of the premium offered for their shares is not relevant. The merger agreement was entered into with Baker Hughes, not its shareholders, creating a disconnect between the party suffering loss and the party entitled to the contractual remedy.

For a target worried about enforceability, we think that there may be an alternative approach of structuring a reverse break fee as facilitation fee for the target to co-operate to put the acquisition proposal before shareholders. In Paciocco v ANZ Bank the Court found that a fee for an additional benefit may not be characterised as a penalty. That would assist the target to resist any argument that the fee was not recoverable.

A NEW ZEALAND PERSPECTIVE

An interesting approach is that taken under the New Zealand Takeover Code. This expressly allows a target to recover costs associated with a takeover bid, even where no cost recovery agreement is in place. This provision was used by Kathmandu in June 2016 to bring an action against Briscoe in the New Zealand High Court to recover NZ$3 million in costs incurred after Briscoe's non-recommended takeover bid for Kathmandu failed.

CONCLUSION FROM COMPARING PRACTICES

Our review shows that Australian practice on reverse break-fees is biased towards specifying material breach by the bidder as the only risk for a bidder to bear and the price of that risk is arbitrarily set at the same size as the target break fee.

US market practice originally had a similar approach to the Australian position. For example, many US transactions in 2005-2007 had a reverse break fee that was the same size as the target's break fee. However, an increase in bidders failing to complete deals during the global financial crisis resulted in targets questioning the logic of this approach and led to an increase in reverse break fees.

We expect to see Australian target companies increasingly seeking added protection for themselves by requiring a reverse break fee to cover situations where a key approval is not obtained, even if that failure has occurred despite the best efforts of the bidder. Under current practice, a failure of a regulatory condition may not lead to a payment as there may not have been a 'material breach' by the bidder as required by typical agreements.

Further, we expect that targets will seek to properly price the risk of deal failure where that is due to breach by the bidder to deliver a key approval. There is no logic, in our view, for a reverse break fee to necessarily be the same as the target break fee. The 1% rule of thumb suggested by the Takeovers Panel for target break fees is, of course, inapplicable. That rule is driven by the need to prevent break fees from deterring competition or acting as a coercive factor on target shareholders. A reverse break fee does not generally give rise to those concerns.

A related point is whether the reverse break fee is to be the exclusive remedy that target can claim. If it is, the reverse break fee can be likened to an option fee that the bidder can pay to terminate the transaction. That may be inappropriate if the reverse break is a lowly 1% of transaction value.

Of course, context will always be important in setting the tone for these negotiations, with the attractiveness of the offer for target shareholders and the likelihood of further bids being relevant considerations.

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MORE INFORMATION

For information regarding possible implications for your business, contact Rodd Levy.

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