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REVERSE BREAK FEES IN UK PUBLIC TAKEOVERS

26 February 2016 | Australia, Brisbane, Melbourne, Perth, Sydney
Legal Briefings – By **Gillian Fairfield**

Following the abolition of break fees in the UK, market participants also expected to see the end of reverse break fees. However, the opposite has proved true. Reverse break fees have become so prevalent that the UK Takeover Panel has needed to step in and regulate them. This article discusses the regulatory concerns of the UK Takeover Panel in relation to reverse break fees.

SUMMARY

- Break fees and other forms of deal protection are now prohibited in the UK but reverse break fees per se are not prohibited.
- It was anticipated that reverse break fees would happen less in practice, given that a bidder could not ask for a reciprocal break fee from the target.
- In fact, reverse break fees have not disappeared from practice and have recently been used in a number of public offers, in particular when a bidder is facing significant anti-trust issues which present significant deal risk.
- However, some bidders have overstepped the mark in terms of negotiating the break fee triggers with the target. There are accordingly a number of issues to consider when agreeing to a reverse break fee and the UK Takeover Panel has recently raised concerns about how reverse break fees are being used.

WHAT IS A REVERSE BREAK FEE?

A reverse break fee is a fee payable by a proposed bidder to a target of a proposed takeover offer if that offer does not proceed for specified reasons, such as a failure of the bidder to obtain shareholder approval or a failure to obtain regulatory approval for the offer.

Reverse break fees are generally designed to compensate the target for losses caused by the offer not proceeding (including, for example, advisers fees and the time dedicated by management to the offer). Reverse break fees can also provide an incentive for the bidder to comply with its obligations under a bid conduct agreement and to underline a bidder's confidence in the deliverability of an offer.

RESTRICTION ON BREAK FEES UNDER THE UK TAKEOVER CODE

Since September 2011, traditional break fees (i.e. payable from a target to a bidder) and all other forms of deal protection which impose obligations on a target in the UK are subject to a general prohibition under the UK Takeover Code. Such deal related arrangements are only permitted, with the consent of the UK Takeover Panel, in certain very limited circumstances, such as when a target is seeking to encourage a competing offer following receipt of a hostile bid or in a formal sale process.

This general prohibition on deal protection came into force in response to the controversial takeover of Cadbury by Kraft, which prompted a vast amount of debate along the lines that bidder companies always had the upper hand over the target. This general prohibition was intended to address the Panel's concern that break fees, non-solicitation agreements and other deal protection measures had become such a standard package that the target felt obliged to provide it in every situation, and therefore was tied up to an unacceptable extent which discouraged competing bids or the target's flexibility to reject an unwanted bid. The prohibition was one of a number of measures introduced by the Panel at the time with the aim of redressing the balance in favour of the target and creating a level playing field for bidders and would-be bidders.

PERMISSIBLE REVERSE BREAK FEES UNDER THE UK CODE

In the UK, reverse break fees are not prohibited by the Takeover Code as the prohibition focuses on what the target company is signing up to, and does not extend to promises coming from the bidder (provided the transaction is not a reverse takeover under the UK Takeover Code, i.e. where the bidder may need to increase its issued share capital by more than 100% as a result of the offer).

Reverse break fees are increasingly common in the UK and are particularly relevant if the bidder's offer carries a significant risk of rejection by regulatory or competition authorities or a risk that its own shareholders may fail to pass any resolutions necessary to enable completion of the acquisition.

The restriction on targets giving break fees has an impact on the structuring of reverse break fees. When the prohibition on break fees was first introduced, it was anticipated that reverse break fees may also fall out of favour. Break fees and reverse break fees were often reciprocal, so it seemed that if the target could not offer a break fee, it may be less likely to secure one from the bidder.

However, bidders remained prepared to offer reverse break fees but began thinking about what they could ask for from the target in return. It is relatively common for reverse break fees to be conditioned upon the target directors not changing their recommendation but bidders also began expanding this concept so that reverse break fees would not be payable if the target directors were actively seeking, or engaging with, other potential bidders. Such conditions began to look a lot like the deal protection mechanisms that had been prohibited, i.e. target boards were incentivised not to engage with competing bids. This led to the UK Takeover Panel stating (in Practice Statement No. 29) that it felt bidders were pushing this practice too far, and that it was concerned with the triggers for the payment of reverse break fees.

While the Panel considers that it is acceptable for the payment of a reverse break fee to be conditional upon the target having taken or not taken certain action, it is not considered generally acceptable if there is an obligation on the target to take, or not take, that action. When expressed as a general theory, this distinction is highly nuanced and will require detailed consideration on a case by case basis to determine what effect a condition will have on the target board (for example, when not taking certain action means a target board loses out on a large break fee, then the target board might be forgiven for feeling that a choice has turned into an obligation).

The UK Takeover Panel considers that conditions for the payment of a reverse break fee would not be permissible if they could have a detrimental effect for offeree shareholders by:

- deterring potential competing bidders from making an offer thereby denying offeree shareholders the possibility of deciding on the merits of a competing offer, and/or
- leading a competing bidder to make an offer on less favourable terms than they otherwise would have done.

It is easier to illustrate what is acceptable and what is not by way of example. Examples of conditions to the payment of a reverse break fee that would not be permitted in the UK would include conditions that the target:

- does not engage in discussions with competing offerors,
- does not provide information to competing offerors beyond the information which is required to be provided in accordance with the UK Takeover Code,
- notifies the bidder of any approach by a competing bidder and/or the terms of any such approach, or
- affords the first bidder an opportunity to match or improve upon a higher competing offer before the target board recommends a competing offer.

Bidders will want as much control as possible over when an obligation to pay the reverse break fee is triggered. Bidders will seek this control by limiting the events in which the reverse break fee becomes payable to circumstances requiring an act or omission of the bidder, for example the withdrawal of the bidder board's recommendation to its shareholders to vote in favour of the acquisition. Whereas targets will normally seek a much broader condition for the payment of the reverse break fee, for example, if there is a "naked" no vote, that is the shareholders of a bidder voting against an offer notwithstanding that the bidder board has recommended they vote in favour.

In our experience, it is often the case that bidders inadvertently raise the possibility of a reverse break fee simply through using overly confident language about deal deliverability: whereas it seems an easy promise at the indicative offer letter stage to make the claim that 'we are confident that our shareholders will support this transaction' or 'we have a high level of confidence that all regulatory consents will be received', this can lead to a target request that the bidder demonstrate that confidence by offering a break fee.

RECENT EXAMPLES OF REVERSE BREAK FEES IN THE UK

In 2012, Glencore International plc and Xstrata plc entered into a reverse break fee agreement under which Glencore (the bidder) agreed to pay to Xstrata (the target) a fee of £288 million (inclusive of any irrecoverable VAT), in the event that Glencore's board withdrew, amended, modified or qualified its recommendation of the merger or resolved or agreed to do the same so as to cause the merger not to proceed.

In connection with AbbVie Inc.'s offer for Shire plc (announced in July 2014), the parties agreed a co-operation agreement whereby, in the event that AbbVie's board's withdrew its recommendation, a reverse break fee of approximately US$1.635 billion (representing 3% of the deal value) would be payable to Shire if AbbVie stockholders did not approve the adoption of the US Merger Agreement at an AbbVie stockholder meeting or such a meeting did not occur by 14 December 2014. On 21 October 2014, AbbVie announced that it had agreed with Shire to terminate their proposed merger following the decision by AbbVie's board to withdraw support for the proposed transaction due to the impact of the U.S. Department of Treasury's changes to the tax rules. AbbVie was then released from its obligation under the Code to proceed with the offer, and AbbVie paid the reverse break fee.

It is increasingly common for bidders to agree a reverse break fee where the offer was conditional, and in some cases pre-conditional, on obtaining various anti-trust and other regulatory clearances across a number of jurisdictions (thereby involving significant work and co-operation on the part of the target company). This is in part driven by the increasing number of international jurisdictions whose antitrust/merger control regimes purport to catch international transactions with little or no connection to the relevant jurisdiction.

OTHER CONSIDERATIONS UNDER ENGLISH LAW IN RELATION TO REVERSE BREAK FEES

In addition to the restrictions in the UK Takeover Code, a UK bidder who is considering giving a reverse break fee will need to consider the following legal issues:

- financial assistance – this will only need to be looked at from the bidder's perspective if the bidder is issuing shares as consideration,

- UK Listing Rules – if the bidder is subject to the UK Listing Rules, the bidder's directors will need to consider the provisions in the UK Listing Rules, in particular the requirement that a reverse break fee be treated as a Class 1 transaction if the total value of the fee(s) exceeds 1% of the market capitalisation of the listed company. If the bidder controls more than 10% of the target a reverse break fee may also constitute a related party transaction for the purposes of the UK Listing Rules,

- the Companies Act 2006 – directors of a bidder proposing a reverse break fee will need to be cognisant of their duties under the Companies Act 2006. In particular, they should test whether the bidder really needs to give the break fee in order for the deal to succeed, and

- penalties – under English common law any sum payable on a breach of contract which is out of all proportion to the innocent party's legitimate interest in enforcing the counterparty's obligation may be deemed a penalty and unenforceable as to the extent of the excess. However, a reverse break fee will not be a penalty if it is payable upon the occurrence of a certain event (e.g. a change of recommendation of the bidder board) rather than a breach of undertaking.

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