

# M&A BuildingBlocks

## Termination Clauses and Break Fees

When negotiating a big and exciting transaction, the last thing the parties want to think about is what happens if the deal goes sideways. However, the clauses that deal with this possibility are some of the most important and highly negotiated clauses in M&A transactions. With that in mind, in this Building Block we will discuss some of the key considerations in relation to termination clauses and break fees.



# Key Issues/Process Points

## Termination Clauses

### 1 What is a termination clause?

Termination clauses, as the name suggests, are meant to allow a party to terminate its obligation to complete a transaction if the conditions in that party's favour are not satisfied, or in certain other events. Fundamentally, a termination right allows a party to walk away from the deal if any one of a specified set of triggers happens (or fails to happen).

### 2 Why do we need termination clauses?

If a transaction can be signed and closed simultaneously, there is no need for a termination clause or break fee because there is no interim period between signing and closing during which circumstances may change or conditions may fail leading one party to want out of the deal. While sign and close transactions may be possible for private company targets (assuming no regulatory or third party consents are required), the need for shareholder participation when the target is a public company means there will always be a delay of some sort between signing the deal and closing, either to allow shareholders to vote on the transaction or to tender to a take-over bid. That is just one example, however. Many other steps, approvals and other conditions required to complete a transaction often cannot be initiated or resolved until a signed agreement is in place. Some of these are dependent on parties and circumstances outside the control of the contracting parties and include commercial party approvals, such as obtaining financing or obtaining the waiver of a right of first refusal, and regulatory items such as competition or foreign investment approval. Depending on what is involved, satisfaction of a condition could take several months.

### 3 What are some typical termination triggers?

Some examples of typical termination triggers include: (i) the parties mutually agree to terminate; (ii) failure to obtain shareholder or regulatory approvals; (iii) changes in law or a court order preventing the deal; (iv) lapse of too much time without closing having occurred (i.e., the "outside date" having been reached); (v) the other party breaches its representations, warranties or covenants; (vi) a superior proposal to acquire the target company is made and the target board recommends to the target shareholders (pursuant to the board's fiduciary duties) that they accept the superior proposal; (vii) the target or its business suffers a material adverse change or event; and (viii) a threshold for exercise of dissent rights is exceeded, or other conditions precedent not being met.



# Break Fees

## 1 What is the purpose of break fees?

Break fees are a reflection of the fact that mergers and acquisitions can be expensive, time consuming and risky. They take management and employee focus away from normal business operations – and this can be true of both the buyer and the target. A deal can fail to be completed due to many reasons, including failure of a condition that is outside the control of the parties, or due to breach by one of the parties.

Break fees were originally designed to address this situation from the point of view of the buyer. Buyers were vulnerable because most transactions involving a public company included an escape clause for the target's board of directors – the so-called “fiduciary out”. Essentially, such a clause was designed to allow a target's board of directors, after having approved a sale transaction, to be able to cancel the transaction in order to accept a subsequent better offer from a third party. To compensate the original buyer, which had now lost its deal but whose work had contributed toward enhanced value to the target's shareholders, the target would be required to pay a break fee upon accepting the better offer.

Break fees also act as a deal protection measure. Any third party proposing to make a better offer would have to take into account that the target must pay a break fee, thus increasing the total cost of the transaction. This aspect of break fees has made them subject to judicial and regulatory scrutiny. In Canada, break fees are allowed if they are considered to be reasonable (although in other jurisdictions, such as the U.K., they are not allowed).

While break fees are payable to the buyer, reverse break fees are payable by the buyer to the target and are intended to compensate the target for risks of the buyer not closing. Just as importantly in many cases, the reverse break fee is intended to cap the liability of the buyer in the event it fails to close; in other words, if the buyer pays the target the reverse break fee, the target is then not permitted to sue the buyer for greater damages or for specific performance. Such clauses were initially found most often in deals involving private equity purchasers.

Similar to a break fee is the expense reimbursement clause. These clauses, generally in favour of a buyer, may apply in the event of a termination where the break fee is not payable. The purpose of the clause is to compensate a party for expenses actually incurred where the deal is terminated for reasons outside the control of the parties. The amount payable is typically much smaller than what would be payable pursuant to a break fee.

## 2 When are break fees payable?

Not all exercises of a termination right give rise to payment of a break fee. The paradigm for payment of a break fee to the buyer is where either the buyer or target terminates the agreement because the target no longer supports the buyer's offer and has approved a superior offer. Conversely, if the agreement is terminated by the target because the buyer has breached and failed to close, payment of a reverse break fee would be triggered.

Beyond these most common payment triggers, the parties may negotiate other transaction specific payment triggers associated with various termination rights. For example, failure to receive a competition or foreign investment approval could be a trigger for a reverse break fee if the target views the risks in this regard as otherwise being unacceptably high.

## 3 Amount of Break Fees

The size of a break fee payable in the context of a particular transaction will depend on a number of factors including the size of the transaction, the process leading up to the transaction (e.g., an auction; unsolicited approach; white knight), risk of the transaction being upset by a competing offer, and other factors. Generally, in Canada, break fees in the range of 1% to 5% have been considered to be reasonable depending on the transaction, with reverse break fees often being higher.

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