Canadian Coalition for GOOD GOVERNANCE

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CANADIAN COALITION FOR GOOD GOVERNANCE

DISCUSSION PAPER ON "BREAK FEES"

Purpose of This Document

Because the Courts have been deferential to the amount of the break fee, preferring to let the market decide the quantum and other terms, and because investors are seldom, if ever, involved in the negotiations of these fees, the CCGG members believe that this document, which highlights some of the delicate issues to be considered in drafting break fees and the fact that the general level of discomfort of CCGG members increases with the size of the break fee expressed as a percentage of the enterprise or equity value, is an important input to a well advised board that may be in a position to negotiate a break fee.

Break Fees and Deal Protection Generally

"Break fees" or "termination fees" are fees which are agreed to be payable to a bidder in certain circumstances by a target company whose directors have agreed to support a negotiated acquisition transaction by the bidder. They can occur in the context of both friendly and hostile takeovers of public companies, but they are agreed to consensually by the target directors as part of an overall negotiated acquisition package.

Once a company is "in play", the directors of the target company have an overriding duty to seek the highest value for the securities of the target company. Generally, this duty is performed by actively canvassing the market for competing bids or "alternative transactions" that maximize shareholder value. Typically, but depending upon the circumstances, the board creates a special committee of independent directors, retains investment advisors to seek bidders or propose alternative transactions, engages legal counsel to advise the independent committee, and undertakes a formal auction process for the company.

A common problem encountered by a board trying to attract an acceptable or competing bid is the high cost (both in terms of time and money) and "deal uncertainty" faced by a potential suitor entering into the process and "stepping up" to make an acceptable or superior firm offer. In attempting to induce an acceptable or superior bid, the board is usually met with a bidder requesting what is commonly referred to as "deal protection" – mechanisms to ensure that its deal has an acceptable probability of being completed, with downside protection for the bidder if another trumping bid emerges that it is not prepared to match.

Commonly used "deal protection" mechanisms (which are set out in a "Support Agreement") are:

- a commitment from the target company that it will cease actively trying to sell itself (a "no shop"), subject to a "fiduciary out" if the target company is approached by another bidder;
- a right to match another superior offer; and
- break fees or, more formally, "support agreement termination fees".

These deal protection mechanisms are always subject to the ability of the board to accept a superior offer from a different bidder – which is often referred to as a “fiduciary out” provision – and other “escape hatches” and terms which are usually heavily negotiated by the target company and the bidder.

Deal protection should be considered in light of the overall Canadian regulatory environment for take-over bids, which includes such features as “poison pills” and the need for fully financed deals (a bid must be fully financed which requires the commitment of significant capital while the bid is outstanding).

Amount of Break Fees

Break fees are generally a fixed dollar amount, and are often negotiated based on a percentage of the total equity (or in some cases enterprise value) of the target company. The break fee is intended to reimburse the suitor not only for its out of pocket expenses, but also for its senior management’s time and effort, the opportunity cost of devoting most of its energy as an entity to the deal and the cost of tying up its capital.
As a result, the dollar amount of break fees varies from situation to situation and is dependent upon a number of factors, including the conditionality of the offer, the trigger mechanisms, the other agreed to deal protection mechanisms, as well as, perhaps most importantly, the relative bargaining power of the parties.

In the U.S., break fees are generally in the 2.8 to 3.4% range, generally decreasing as the transaction value increases. Break fees in Canada are similar, averaging 3.0% from 2001 to 2005.

Conditions of Payment of Break Fees

A bidder and a target company usually have significant negotiations as to when and in what conditions a break fee is "triggered" and the fee becomes payable. For example, is the fee payable when the board of the target company agrees to support a superior offer (subject to shareholder approval and other possible conditions), or is it payable when the superior offer is actually completed? What happens if the superior offer is not actually closed, perhaps because a key condition could not be fulfilled? What happens if shareholders do not tender their shares to a tender offer or vote to approve a bid made by way of plan of arrangement, even though supported by their board of directors?

What constitutes a "superior offer" is also negotiated, particularly in all or partial stock deals or if the two deal structures are significantly different – an offer can be worse financially, but superior in non-financial terms. For example, a $100 per share stock exchange bid that is conditional (such as being subject to anti-trust approvals) in favour of the bidder, may not be superior to a firm $95 per share cash bid.

The View of the Courts

Break fees have been the subject of several court challenges and decisions in the United States and Canada, often brought by a competing bidder who states that the break fee and other deal protection mechanisms are material impediments to its bid.

Generally, the Courts have upheld negotiated break fees and related deal protection mechanisms with a "fiduciary out" as a valid exercise of the authority and business judgment of the board of directors of a target company, and the Courts have not been prepared to override the business judgment of a well-advised and experienced board. The Courts have also been deferential to the amount of the break fee, letting the market decide the quantum and other terms.

For example, in WIC Western International Communications (1998), Blair, J confirmed that, where business decisions have been made honestly, prudently, in good faith and on reasonable and rational grounds, the Courts will be reluctant to interfere and usurp the board of directors' function in managing the corporation. Break fees were seen by the Court as effective inducements and acceptable in appropriate circumstances, including to induce a competing bid which offers better value and represents a commercial balance between the potential negative effect as an auction inhibitor and its potential positive effect as an auction stimulator. In this seminal case, the court took judicial notice of an acceptable break fee range of 2.5% to 5% of equity value. US cases have later discussed whether the fees should be based on the deal size or the generally larger total enterprise value of the target.

Concerns about Break Fees

Despite the position of the courts, CCGG members are concerned about the size of break fees and the potential for these fees to deter competing bids. In addition, members are not satisfied with the level of disclosure of break fees, in particular the terms and rationale for entering into such an agreement.

Although evidence suggests that break fees, on average, have not been trending higher in recent years, CCGG members are concerned about the possibility that the size of break fees generally may again rise, or with respect to a specific transaction, be set unacceptably high.

Position of the CCGG

Full Disclosure: Any board that agrees to a break fee should be prepared to justify it to shareholders with full disclosure and rationalization. Full disclosure of the terms of all “deal protection” should be provided in the directors’ circular, subject to not disclosing competitive information which might damage the target’s ability to negotiate with other bidders.

Members will likely accept break fees negotiated by well advised, competent boards and rely on their business judgment to determine the amount and other provisions of the break fee. This recognizes that break fees have been upheld by the courts, are only one component of a complex transaction and will have been balanced by the board with other provisions of the deal.

CCGG members do not wish to impose a single bright line test representing a tolerable maximum for break fees, but wish to make it clear that break fees will receive increasing scrutiny from institutional investors as the magnitude of the fee becomes larger and larger with deal sizes increasing.