CARVING UP THE RISK

The rising use of reverse break fees

Private M&A deals are frequently conditioned on multiple merger control approvals — a risk which can be quantified and allocated between the parties with a break fee. We take a look at the pros and cons of these fees and why they're on the rise.

In the last decade, the number of merger control regimes worldwide has shot up from about 70 to 130. Because notification triggers tend to have more to do with the size and geographic spread of the parties doing a deal than whether it raises competition concerns, many transactions may need clearance in a long list of countries even when there is little overlap between the buyer's and seller's business lines.

Growing confidence to pursue aggressive deals is also leading to more transactions that raise competition concerns, including add-on deals by private equity funds. The rise in the number of these add-on deals means that PE funds are bumping up against tricky competition issues as they strive to increase market share or complement existing portfolios.

Greater scrutiny by merger control authorities is causing major delays in transaction timetables and creating more uncertainty. In more complex cases, the government's stance has resulted in the buyer having to sell off part of the overlapping business and even the deal collapsing.

In April 2015, for example, Applied Materials and Tokyo Electron walked away from their proposed US$29 billion merger because of opposition from the US Department of Justice. A month later, Scandinavian telecom operators Telenor and TeliaSonera abandoned their plan to combine their Danish operations after failing to secure EU antitrust approval.

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Given the rise in deal uncertainty, more buyers and sellers are trying to quantify and allocate the antitrust risk between them. A menu of risk-shifting provisions is available. The options range from seller-friendly "hell or high water" clauses that require the buyer to pay the seller the agreed consideration for the target business even if the buyer is blocked from completing the acquisition, to commitments on how much effort the buyer is required to expend to obtain approvals.

One downside to these agreements is that if the parties specify which assets the buyer must divest to obtain clearance, it could provide antitrust authorities with a roadmap for the areas of greatest competitive concern. In less complex deals in which there is scope to argue for clearance without remedies, it may be better not to include these clauses . On the other hand, in more complex cases in jurisdictions such as the US and EU, agencies are becoming more familiar with these provisions and specifying possible carve-out assets probably only involves a small incremental risk for the parties.

We're increasingly seeing the parties negotiate a reverse break fee to manage antitrust risk. These clauses can be useful if the buyer isn't prepared to take on the antitrust risk or if the parties disagree on how big that risk is, particularly when the seller may be inclined to accept a lower bid from an alternative bidder with a perceived lower antitrust risk. The fee shows how far a buyer is willing to go to get a deal through while capping its liability. At the same time, it guarantees the seller compensation if the deal fails for antitrust reasons. Plus, if the reverse break fee is big enough, it won't be as easy for the buyer to escape considering divestures to get the deal through.

Reverse break fees can, however, delay the merger control timetable if the buyer decides to challenge the regulator's concerns from every angle. One variant we might see in a transaction that is at risk of progressing slowly is a ticking fee. Unlike a reverse break fee which only becomes payable to the seller when the deal is terminated, ticking fees require the buyer to start making payments when the antitrust timetable starts to slip, which encourages the buyer to make filings and solve antitrust concerns quickly.

Given that reverse break fees represent a huge potential cost to buyers, having local knowledge of merger rules and conducting risk assessments can help reduce the long list of merger control approvals a transaction needs. Pre-filing consultations with the local competition authority can also ensure the deal is reviewed quickly, without holding up the wider deal timetable.

Plus, in more complex deals, it is possible to consult with antitrust agencies early to find out what kind of remedies they might require for approval. That can provide the time and space the parties need to work out what they may be willing to divest in a worse case scenario and even enable them to address the antitrust risk upfront by modifying the deal. All of this footwork arms the parties with the analysis they need to quantify the risk and agree to a carefully considered reverse break fee which will be attractive to both the buyer and seller.

How much is too much?

We are seeing a fairly wide range of reverse break fees as a percentage of deal value. Some are as high as more than 7%, such as in the Verizon/Vodafone merger where the parties agreed a reverse break fee of US$10 billion. The break fee in the Pfizer/Wyeth deal was US$4.5 billion, more than 6% of deal value.

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