Break Fee Restrictions: Where's the Harm?

Jessica Curtis and Sean Pinder

The Takeovers Panel, the primary authority charged with resolving disputes arising within the Australian market for corporate control, defines a break fee as being (Guidance Note 7: Lock-up Devices, s. 7.15):

... an arrangement entered into between a bidder or potential bidder and the target of a proposed takeover bid or merger. Some form of consideration will be payable by the target if certain specified events occur which have the effect of preventing the bid from proceeding or causing it to fail (triggers). These events will typically be outside the control of the bidder (but not necessarily of the target or its shareholders).

Break fee agreements evolve from merger negotiations which are inherently ‘friendly’ and thus do not appear in hostile takeover bids. The process is initiated when the target and potential acquirer enter into discussions, commencing with a negotiation of the terms of the merger agreement. As a matter of course the bidding party will undertake extensive due diligence and through continued negotiation the deal premium and break fee are agreed to. The agreement is then made public along with the details of the break fee agreement when the offer closes. This is followed by the release of the target and bidders statements. Disclosure of the break fee agreement in these documents will identify the particular circumstances (the ‘triggers’) that render the break fee payable (for example, target directors not recommending the bid, or shareholders of the target accepting another offer thereby causing the initial bid to fail). So long as none of the triggers occur before the offer closes the merger will be successful and no break fee paid.

Break fee agreements have been a common feature of the US market for corporate control for at least 15 years. Up to 42 per cent of all completed and withdrawn mergers in that market included some sort of break fee agreement (See, for example, Bates and Lemmon, 2003; Officer, 2003; and Rosenkranz and Weitzel, 2005). In Australia, the incidence of break fee agreements has increased significantly in recent years, increasing from only three deals in the year 2000 (representing 3.5 per cent of bids made) to 49 deals in 2006 representing 43.4 per cent of the offers made (Connect4 database). Table 1 provides details of the incidence, and size, of break fees over the last six years in Australia.

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Table 1: The Changing Importance of Break Fee Agreements in Australia

<table>
<thead>
<tr>
<th>Year</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of deals with break fee agreements</td>
<td>3</td>
<td>5</td>
<td>10</td>
<td>15</td>
<td>20</td>
<td>19</td>
<td>49</td>
<td>121</td>
</tr>
<tr>
<td>Percentage of deals with break fee agreements</td>
<td>(3.53%)</td>
<td>(6.10%)</td>
<td>(17.24%)</td>
<td>(19.74%)</td>
<td>(27.03%)</td>
<td>(31.15%)</td>
<td>(43.36%)</td>
<td>(22.04%)</td>
</tr>
<tr>
<td>Median size of break fees</td>
<td>$6.40M</td>
<td>$5.00M</td>
<td>$1.00M</td>
<td>$1.00M</td>
<td>$2.73M</td>
<td>$1.00M</td>
<td>$1.59M</td>
<td>$1.80M</td>
</tr>
<tr>
<td>As a percentage of deal value</td>
<td>1.17%</td>
<td>1.18%</td>
<td>0.96%</td>
<td>1.00%</td>
<td>1.00%</td>
<td>0.88%</td>
<td>0.98%</td>
<td>1.00%</td>
</tr>
<tr>
<td>Average size of break fees</td>
<td>$14.9M</td>
<td>$49.65M</td>
<td>$1.14M</td>
<td>$6.47M</td>
<td>$4.01M</td>
<td>$29.10M</td>
<td>$5.21M</td>
<td>$10.62M</td>
</tr>
<tr>
<td>As a percentage of deal value</td>
<td>1.08%</td>
<td>1.63%</td>
<td>1.28%</td>
<td>0.98%</td>
<td>1.09%</td>
<td>0.92%</td>
<td>1.99%</td>
<td>1.06%</td>
</tr>
</tbody>
</table>

Note: This table shows the number (and percentage) of bids that included break fee agreements between the years 2000 and 2006 inclusive. It also reports the median and average size of the agreed break fees expressed in both dollar terms and as a percentage of the initial deal value.

Source: Connect4 database.
The importance of break-fee agreements is evident not only in their incidence, but also with respect to the significance of the deals in which they are utilised. For example, consider the recent high profile merger between WMC Resources and BHP Billiton. In late 2004 WMC became the target of a hostile takeover bid from Xstrata. The directors of WMC declined to endorse the offer and released statements saying they would pursue all other options. The board subsequently entered negotiations with BHP Billiton who, having been induced by the break fee, announced a cash offer to acquire the entire share capital of WMC. This valued WMC at $9.2 billion, and a premium of $800m to Xstrata's offer ($0.65 per share). The terms of the break fee agreement were contained in the deed of undertaking and included such triggers as a successful competing takeover proposal, or the directors of WMC withdrawing their approval of the deal. Andrew Michelmore, chief executive of WMC said at the time that '… (the break fee) was a requirement to get what we believe is a very good offer on the table' (Phaceas, 2005). Further it is made clear in the deed of undertaking that the break fee was entered into 'in order to secure the offer'. Mid-way through 2005 BHP Billiton became entitled to 90.6 per cent of voting power and proceeded with compulsory acquisition of WMC.

The use of break fees in Australia is regulated through the application of Guidance Note 7: Lock-up Devices (GN7) which was first issued by the Takeovers Panel in December 2001 (later revised on 15 February 2005). This article argues that these regulations are misguided in that they place excessive emphasis on protecting shareholders from potential agency costs while ignoring the benefits that may flow to target company shareholders when target management is able to employ a break fee as simply another tool when negotiating with potential acquirers. We describe a number of alternative theories which predict different wealth effects on target company shareholders. We then go on to describe empirical evidence that suggests a positive relationship between break fees and outcomes for target company shareholders from the US market where break fees are not subject to the same restrictive guidance as operates in Australia. We then explain how the adoption of the current approach by regulators is mistakenly based upon the position taken by the equivalent regulator in the UK where the risks faced by acquirers, and hence the compensation needed to be paid to them for undertaking bids, is markedly different to that facing Australian acquirers. Finally, we propose amendments to GN7 to bring the Australian regulatory view of break fees into line with that adopted in other countries, such as the US, and point out that alternative sources of regulation already offer target company shareholders sufficient protection against a wealth transfer to entrenched managerial teams and friendly acquirers.

**Alternative Theories of the Impact of Break Fee Agreements**

The literature is divided with regards to the possible impact of break fee agreements upon the efficiency of the market for corporate control as well as the wealth of shareholders in the target firm. There are at least four alternative approaches to explaining why target managers may voluntarily agree to their firm being bound by a break fee agreement. It has been suggested that break fees are an example of an agency cost imposed upon target company shareholders by
entrenched management teams seeking to maximise their own personal utility by
diverting control of the firm to a specific favoured acquirer. The cost to
shareholders arrives in the form of a reduction in the premium that they may have
received were alternative bidders not dissuaded from bidding by the presence of
the break fee agreement, which if triggered, reduces the value of the target to
other potential acquirers (see Bates and Lemmon, 2003; Officer, 2003; and
Rosenkranz and Weitzel, 2005).

An alternative rationale for the existence of break fees involves the
recognition that potential bidders are required to expend significant effort and
resources in assessing the target's suitability for acquisition. Moreover, these
costs are deal-specific and the potential acquirer runs the risk that having
expended the effort, an alternative bidder (perhaps solicited by the target firm)
enters the fray and free-rides upon the information already uncovered. In this
setting, the break fee agreement is viewed as a cost-compensation device that
grants the initial bidders the confidence to undertake their enquiries without fear
being out of pocket if their bid is ultimately unsuccessful. Consequently, and in
contrast to the agency cost-based analysis of break fees, the cost compensation
approach suggests that participation in a break fee agreement enables target
management to encourage more intense bidding by alternative acquirers,
ultimately resulting in an increased takeover premium being received by target
comp company shareholders.

Agreeing to a break fee may also serve to enable target management to send
a credible signal to the bidder, and the market more generally, of its commitment
to the merger process. A reasonable concern for any initial bidder is that
following the discovery and disclosure of the synergies that would be available if
the merger was to proceed, the target then reneges upon the bid and implements
other, more fruitful, non-merger alternatives. Essentially, agreement to a break
fee helps overcome the asymmetry in information held by the bidding and target
firms about the planned course of action once the merger synergies are revealed,
and, as has been demonstrated by Klemperer (1998), this can result in higher
premiums being enjoyed by the target company shareholders.

Rozenkranz and Weitzel (2005) argue that it is more helpful to analyse break
fees within the context of a simple bargaining process between the bidding and
target firms. Their theoretical formulation suggests that by offering a break fee to
the initial bidder, the target is able to secure a bid that they can then shop around
to other alternative bidders. These alternative bids, or ‘outside options’, are then
used in turn to increase the premium from the initial bidder. Rozenkranz and
Weitzel demonstrate, under a certain set of conditions, that the presence of a
break fee agreement will increase the premium received by target company
shareholders. In equilibrium, the break fee agreement may be used in this way
when the value of the target firm’s outside options are neither too low or too high
relative to the value of the initial bid. If the value of the outside options is too low
then they will not represent a viable alternative with which to negotiate a better
deal from the initial bidder. If the value of the outside options is too high relative
to the initial bid, then the attractiveness of the outside option will dominate and
the target will be unable to secure a more attractive bid from the initial bidder,
even after agreeing to a break fee. Importantly, the authors report strong
empirical evidence in support of their theory in that their analysis of 1,232 mergers in the US between 1986 and 2003 demonstrates that the size of the break fee negotiated between the two parties is positively (negatively) related to the bargaining power of the bidder (target) firm and positively related to the takeover premium offered by the bidding firm.

To summarise:

- Agency cost arguments suggest that break fee agreements have the potential to reduce the wealth of target company shareholders as competition for the firm is adversely affected,
- A cost compensation approach claims that break fees may actually represent fair compensation for the initial bidder's efforts and the risks that they face,
- Information-based models argue that break fee agreements provide a mechanism by which management may help to overcome the asymmetry in information held by themselves versus the market generally and potential acquirers specifically, and
- A bargaining-model approach to break fees demonstrates that target company shareholders may actually be better off if they are able to utilise break fees in their negotiations in order to extract a higher takeover premium from the initial bidder.

Although the alternative interpretations of break fees discussed above are not strictly mutually exclusive, the question of the actual impact of break fee restrictions upon target company shareholder wealth is one that we will now consider.

Restrictions on Break Fees and an Illustration Using Option Payoffs

The Takeovers Panel provides some direction with respect to the circumstances under which a break fee agreement would be acceptable. The Panel's position, as stated in *Guidance Note 7: Lock-up Devices*, involves a 'bright-line' approach to regulation in that it suggests, in section 7.5, that:

To avoid putting pressure on shareholders to accept a bid or lock out a potential competitor, the Panel considers that a break fee should not in general exceed one per cent of the equity value of the target company.

Where the one per cent limit is breached, section 7.20 of GN7 very clearly places the onus on the parties to the break fee agreement to demonstrate that the arrangement is neither anti-competitive nor coercive. While it is feasible for target management to do this, there are very strong reasons why they would be reluctant to attract the attention of the regulators and the market generally by agreeing to a break fee in excess of the one per cent level. The current regulatory approach to break fees has cast a negative pall over these agreements generally as can be readily illustrated by the case of WMC Resources-BHP Billiton where the agreement was labelled by the financial press as a 'disgrace' (Kohler, 2005) and the one per cent fee 'exorbitant' (Freed, 2005). Thus despite the ability of target management to justify the use of larger break fees to the Panel, the
evidence in Table 1 shows significant clustering break fees around the one percent level.

The Panel’s view of break fees is clearly enunciated in section 7.16 of GN7 which states that ‘the break fee might in many cases be viewed as an option fee paid to secure the opportunity for the target or its shareholders to consider’. This characterisation of the break fee as constituting the fee paid by target management (on their shareholder’s behalf) to the bidding firm in return for the granting of an option to sell the firm for a specified price (a put option) requires some analysis.

Consider initially a takeover offer absent a break fee, the payoff to the target company shareholders constitutes a portfolio consisting of a bought (long) position in the underlying share as well as a long position in a put option with an exercise price equal to the bid price, $B$, offered by the potential acquirer. The total payoff to target company shareholders on the date that the offer closes (the option’s expiry date) is simply the greater of the bid received or the amount, $S$, that could be obtained from alternative courses of action such as an offer from an alternative bidder or some type of internal reorganisation such as a divestiture or a spin-off. As with any put option, it is optimal to exercise this one, and accept the bid, whenever the value of the underlying asset, $S$, being the amount that could be obtained through non-merger alternatives, is less than the exercise price, $B$, offered by the bidding firm. The payoff from the put option implied by a standard takeover bid is simply expressed as:

$$\text{Payoff}_{\text{No Breakfee agreement}} = \max(0, B - S) \quad (1)$$

When a break fee is introduced, it is incorrect to simply assume that it can be treated as a sunk cost as one would with a standard option premium. Indeed, the break fee, $F$, is an option premium that is only payable if the option to accept the bid is allowed to lapse (that is, the bid is rejected). This style of option is known as a contingent premium option and has been described in detail by Gastineau (1994), and Kat (1994). The main effect of this feature is that when target company shareholders are faced with their decision as to whether or not to accept a bid, they need to account for the price payable for the option if the bid is rejected. Specifically, target company shareholders will accept a bid whenever the bid price exceeds the value created from alternative courses of action, less the break fee payable when the bid is rejected. The net payoff from the option implied by the takeover bid following the introduction of the break fee agreement (and assuming that the bid price is unaffected by the presence of the break fee agreement), is now:

$$\text{Payoff}_{\text{Breakfee agreement}} = \max(-F, B - S) \quad (2)$$

Two specific effects are readily observable from comparing (1) with (2). First, the payoff to a contingent premium put option may actually be negative as it may be optimal to accept the bid even where it is lower than the amount offered
via other non-merger alternatives, provided you are able to avoid paying the break fee. Second, comparison of (1) with (2) indicates that the introduction of a break-fee has been detrimental to target company shareholders as there is now a cost associated with accepting other non-merger alternatives. This result is consistent with the agency cost idea that suggests that break fee agreements may result in a transfer of wealth from target company shareholders to bidding company shareholders or to entrenched management teams who are able to dissuade regime change by instituting such an agreement. Given this interpretation, it is not surprising that the Takeovers Panel has decided to impose some restriction upon the size of the break fee payable.

There are two things that this interpretation of the break fee fails to account for. First, it is quite possible that in the absence of the break fee, there would not have been a bid in the first place, and hence the comparison of (1) with (2) is fundamentally flawed. Second, and perhaps more importantly, in cases where there is a viable non-merger alternative, the break fee agreement may be able to be used as a negotiating tool by target company shareholders in order to secure a greater slice of the potential synergies on offer from the initial bidder. In option pricing parlance, this would result in the exercise price of the put option, $B$, increasing, which in turn increases the value of the target company shareholder's position. The question of whether the target company shareholder is better off with or without a break fee requires comparison of the upside associated with the increased exercise-bid price against the downside associated with the premium that will be payable if the bid is rejected.

This analysis is consistent with the arguments of Rozenkranz and Weitzel (2005) who effectively argue that the result of the cost-benefit analysis is driven by the degree to which the put option is in (or out of) 'the money'. The put option's 'moneyness' simply reflects the value of the bid relative to the value of the target company shareholder's non-merger alternatives. If the value of these alternatives is relatively low, then the put option is deep in-the-money and the positive exercise price effect, via the increased bid, will dominate. If the value of the alternatives is high, relative to the bid price, then the increase in the probability that the premium will be paid will begin to dominate and target company shareholders may be worse off if a break fee were agreed to.

The preceding analysis has argued that there are cases in which payoffs to target company shareholders may be enhanced when a break fee agreement is entered into. It is now appropriate to consider the empirical evidence demonstrating the actual impact of break fees upon target company shareholder wealth.

**Empirical Evidence on the Impact of Break Fees**

It is important to consider the international evidence of the impact of break fees on target company shareholder wealth for two reasons. Firstly, break fees are a relatively recent innovation in the Australian market for corporate control and, as a consequence of the small sample size, there is no published empirical work to date. Secondly, break fees in the US, where most of the empirical work has been performed, are not regulated using a bright-line approach. Restrictions on break fees have instead been imposed retrospectively in that it has largely been left to
the courts to interpret whether a particular break fee provision constitutes 
shareholder coercion or a betrayal of target management's fiduciary duties. 
Consequently, researchers in the US have been able to observe a spread of break 
fees that are largely unbounded by regulatory constraints, such as the Takeovers 
Panel's one per cent guideline, and hence can answer more fully the question of 
whether shareholders are better or worse off when negotiated break fee 
agreements are in place.

What is the relationship between break fees and the premium received by 
target company shareholders? If break fees represent sweetheart deals with 
friendly white knights and operate to protect entrenched managerial teams and 
deter competing bids, we would then expect to see a negative relationship 
between the presence or size of the break fee and the premium received by target 
company shareholders. However, the overwhelming evidence has been to the 
contrary. Officer (2003) examines 2,511 mergers in the US over the period 1988 
to 2000 and reports that target company shareholders receive a premium that is 
an average of seven per cent higher when a break fee agreement is in place. This 
is supported by Bates and Lemmon (2003) who report that premiums are 
between 3.7 per cent and 6.3 per cent higher when a deal contains a break fee. 
Rozenkranz and Weitzel's (2005) examination of 1,232 successful takeovers also 
finds a positive relationship between bid premiums and the presence of break fee 
provisions. Furthermore, an examination of the share price returns that accrue to 
target and acquirer company shareholders around the time of the takeover (and 
break fee) announcement indicates that these fees are not used as an anti-
competitive device to dissuade the entry of competing bidders. Bates and 
Lemmon (2003) report that while the presence of a break fee increases the 
probability that the deal will be completed, their evidence rejects the notion this is 
to the detriment of target company shareholders. Indeed, when they examined 
the share price reaction to the announcement of a takeover, the presence of a 
break fee was positively associated with target company shareholder returns. 
Further, there was no evidence that share returns to bidders were related to the 
presence of break fees which is contrary to the notion that these fees involve a 
systematic transfer of wealth from target to bidding company shareholders.

The evidence indicates that in circumstances where break fees are not 
constrained, their use has a positive influence on target company shareholder 
wealth. In contrast with the US where break fees average between three and 
four per cent (see Bates and Lemmon, 2003; Officer, 2003; Boone and Mulerin, 
2005), the regulatory environment in Australia has produced break fees that 
noticeably cluster around one per cent. In the face of such overwhelming 
evidence of the positive impact of break fees on the outcomes for target company 
shareholders, it is appropriate to consider the background to the adoption of the 
current approach in Australia.

Background to the Current Regulatory Approach

Guidance Note 7 emanates from the City Code on Takeovers and Mergers ('Codé') 
which regulates takeover activity in the United Kingdom (particularly Rule 21.2 of 
the Code that limits break fees to one per cent of deal value). However,
considering the use of break fees in the Australian context, the adoption of similar standards to the UK is arguably inappropriate.

The bright line approach is founded upon the characterisation of a break fee as a contractual provision for liquidated damages. That is, a break fee is characterised as a pre-estimate by the parties of the likely loss that will occur if the agreement to merge does not transpire. It is therefore appropriate to cap the break fee such that it covers only legitimate out-of-pocket expenses. However, in section 7.22 of GN7 the Takeovers Panel acknowledges that cost recovery is no longer of primary importance in the justification of a break fee. This recognises that break fees can have a broader application than simply as a method of compensation, in the event of a failed bid, which necessitates greater flexibility in their evaluation. (When GN7 was released in December 2001, the primary justification of break fee use was cost reimbursement, whereas when the guidelines were re-released in February 2005 the panel had shifted focus and removed sub-sections that identified the role of break fees in cost recovery.)

Australian companies face significantly more risk when engaging in takeovers than their British counterparts. United Kingdom regulation of takeovers (The Panel on Takeovers and Mergers, 2006:Rule 9) incorporates a mandatory bid rule (MBR) that allows a bidder to acquire more than the 30 per cent threshold in a single pre-bid acquisition provided the company follows up with an unconditional cash offer or cash alternative for the remainder. The Australian model however, does not contain a MBR and has a lower takeover threshold of 20 per cent. Australian companies are therefore prevented from holding as significant a controlling stake in a target before initiating a formal takeover offer (given the absence of the MBR) and restricted to holding a smaller aggregate percentage (due to a lower threshold). Thus they face comparatively more uncertainty in bids for control. To the extent that break fees reduce the risks associated with takeover bids, their use in Australia may act as a partial substitute for the relatively smaller proportion of shares that potential acquirers are permitted to accumulate, relative to bidders in the UK. Consequently, it is entirely reasonable to argue that they should not be subject to the same restrictions as is the case in the UK. (Mannolini and Rich, 2001 argue that a mandatory bid rule, similar to that found in the UK, enables a bidder to reduce the probability that significant losses are incurred in making an unsuccessful bid.)

Finally it should be acknowledged that Australian regulation of takeover activity contains sufficient provisions to ensure the valid objectives of the one per cent guideline are still achieved. The two key hurdles for merger agreements involving break fee provisions remain. That is, the fee must neither be anti-competitive nor coercive. Further, section 7.53 of GN7 draws attention to the existence of additional regulation which may render a break fee provision 'void or unenforceable'. Break fees that realistically deter other bidders would possibly breach the target directors' duties of 'reasonable care and diligence' (Corporation Act 2001 s180) and acting in 'good faith for a proper purpose' (Corporation Act 2001 s181). While the size of the fee may provide an indication of improper motives it is relevant to consider the context in which the bid or merger is negotiated. A further limitation on break fees is that any unjustifiably large break
A Proposal for Reform

Removing the one per cent limit in GN7 should be accompanied by the inclusion of a new guideline emphasising a criterion of shareholder wealth maximisation in sale of control circumstances. This reform is reflective of the 'Revlon duties' applied by US Delaware Courts when it is recognised that a company is for sale.

Under these circumstances the duty of directors changes from the preservation of [the] corporate entity to the maximisation of the company's value at sale for the stockholders benefit. In 2005 the board of Toys 'R' Us Inc successfully used a break fee of 3.75 per cent to attract an offer from KKR Group which represented a 123 per cent premium for shareholders over the pre-auction trading price and a 15 per cent premium to a rival bid from Cerberus Capital Management. Legal analysis of this agreement resolutely endorsed the board's actions emphasizing that the appropriate focus for 'Revlon duties' is the negotiation process and the subsequent result achieved for shareholders.

The proposed guideline of shareholder wealth maximisation in sale of control circumstances is consistent with the current duty of directors to act in the 'best interests' of the company as a whole. The benefits of this proposed guideline are twofold. First, the empirical evidence from the US strongly suggests there is a positive relationship between break fees and bid premiums and the suggested change in regulation would enable shareholders in Australian target companies to enjoy these benefits as well. Furthermore, the adoption of shareholder welfare enhancement as the criterion for the regulation and evaluation of break fee agreements will restrict directors from employing agreements in any circumstance that may detract from target shareholder wealth, irrespective of whether or not the one per cent guideline has been breached.

Mayanja (2002) supports the adoption of shareholder welfare enhancement as a criterion to regulate break fee agreements, and argues that in light of this, the law should be reformed to provide clear guidance to directors using such agreements. He argues that directors should only be able to agree to a break fee provision when it is for the benefit of shareholders, and equates the benefit of shareholders with shareholder wealth maximisation.

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Conclusion

The one per cent guideline is unnecessarily stringent. First, such provisions reduce the flexibility of companies to use break fees to generate higher premiums for target shareholders, an outcome which has been well documented in voluminous research from the US. Second, valid objectives of the guideline such as constraining errant management may otherwise be achieved by existing regulatory mechanisms. Furthermore, it has been shown that the UK regulatory environment, from where the current approach emanates, is not aligned with the circumstances that prospective bidders face in Australia. Consequently reform of the current guidelines would be in the interests of target company shareholders and would improve the efficiency of the market for corporate control in Australia.

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