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A Reminder on Break-up Fees in M&A Transactions

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M&A deal protection measures, such as requirements for exclusive negotiations, no-shop provisions, break-up fees, matching rights and other devices, have long been accepted by the Delaware courts — as long as they do not unreasonably preclude potential bidders who might otherwise want to top an existing offer and provide greater value to a target's stockholders.

Although no one deal protection measure can be analyzed in a vacuum, and each measure must be considered in the context of other protection devices adopted in the particular deal, the Delaware courts routinely find that break-up fees in the range of 3-4% of the transaction's equity value are not unreasonable. In smaller deals, break-up fees may be even higher. The Chancery Court in *In re Answers Corporation Shareholders Litigation*, Consol. C.A. No. 6170-VCN (April 11, 2011), for example, called a break-up fee equal to 4.4% of equity value "near the upper end of a 'conventionally accepted' range," but noted that, in the context of a "relatively 'small' transaction" such as Answers, "a somewhat higher than midpoint on the 'range' is not atypical." And the Court in *In re The Topps Company Shareholder Litigation*, Consol. CA. No. 2786-VCS (June 14, 2007), determined that, although a break-up fee, including payment of the bidder's expenses, of 4.3% was "a bit high in percentage terms," it was "explained by the relatively small size of the deal."

Against that background comes the recent Chancery Court decision in *In re Comverge, Inc. Shareholders Litigation*, Consol. C.A. No 7368-VCP (November 25, 2014). Here, in a challenge to a completed merger, the plaintiffs alleged, among other things, that the board of directors of the target Comverge, Inc. had breached their fiduciary duty by agreeing to a break-up fee of as much as 13% of Comverge's equity value. How'd that happen?

After a difficult negotiation, Comverge agreed to be acquired by H.I.G. Capital, L.L.C. for $1.75 per share in a transaction that valued Comverge's equity at approximately $48,000,000. HIG also negotiated a break-up fee of $1,206,000 if Comverge terminated the deal during a 30-day no-shop period and $1,930,000 if Comverge terminated the deal after the expiration of the go-shop. In either case, Comverge also agreed to reimburse HIG for up to $1,500,000 of expenses. If Comverge were to pay the lower of those break-up fees (including the maximum expenses), the total payable to HIG would be 5.55% of Comverge's equity value; with the higher fee, the total payable would be 7.0% of its equity value.

Citing prior decisions in *Answers and Topps*, referred to above, the Court wrote that "even assuming the lesser 5.55% metric is used … that percentage tests the limit of what this Court has found to be within a reasonable range for termination fees … even for a micro-cap acquisition like this one … in which the case law tends to provide somewhat greater latitude in this regard."

But it gets even more interesting. In connection with the merger agreement, HIG agreed to provide Comverge with a $12,000,000 bridge loan that was convertible into 8,571,428 shares of Comverge's common stock at a conversion price of $1.40 per share.

The plaintiffs argued any other bidder would need to pay at least $1.76 per share to top HIG's offer and repay the $12,000,000 in debt (plus interest at 15%). Alternatively, if HIG elected to convert its note into Comverge's common stock and then tender that stock into a superior offer, the topping bidder would have to pay $3,085,000 more to acquire Comverge than the approximately $48,000,000 HIG had offered. The plaintiffs argued that the $3,085,000 should be considered part of the break-up fee and that, in doing so, the total termination payment would actually be 13% — or more — of Comverge's equity value. The defendants, not surprisingly, disagreed. The Court, however — which, in acting on the defendants' motion to dismiss, was required to determine only "whether it is reasonably conceivable that the [convertible debt] could have functioned, in effect, as part of an unreasonably high termination fee" — concluded that, yes, that was reasonably conceivable.

And what's at stake? For Comverge's former directors, the deal's long done, and so the fight is over whether they are personally liable for breaches of their fiduciary duties by approving the terms of the deal. Unless the parties settle, the Court will ultimately rule on whether the repayment or conversion of the HIG bridge loan should be considered part of the break-up fee and — whatever that conclusion — whether the fee could have had the effect of unreasonably precluding other potential bidders from making topping offers. And would the former directors be protected by the business judgment rule and by provisions of Comverge's charter, insulating them from personal liability for breaches of the duty of care pursuant to Section 102(b)(7) of the Delaware General Corporation Law? Maybe not: the Court warned that "if the [bridge loan is] taken as contributing to the preclusive effect of the termination fee and the expense reimbursements, it conceivably is true that the Board's apparent passive acceptance of those terms without any pushback was 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith'."

For the rest of us, the easy take-away from Comverge is that economic terms that may appear facially unrelated to deal protection — such as a convertible note — might be viewed by unhappy stockholders, frustrated suitors and the courts as unreasonably preclusive. But the bigger picture is the reminder that all deal protection measures must be reasonable under the circumstances. Although every deal is different and the ways in which these devices might be structured and combined are apparently limitless, the courts continue to provide guidance. It's up to M&A lawyers and their clients to pay close attention to that guidance.

For more information on break up fees, please contact **Carl Barnes**.