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Delaware Courts Continue to Provide Guidance on the Parameters of Acceptable Termination Fees

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On October 5, 2010, the Delaware Chancery Court decided *In re Cogent, Inc. S'holder Litig.*, handing Cogent's Board of Directors a clear and decisive victory with respect to its actions in connection with the sale of Cogent to 3M Company.¹ Among other claims, the plaintiff shareholders argued that the deal protection measures Cogent granted to 3M, including a \$28.3 million termination fee, breached the Board's fiduciary duties. The court rejected this claim, and in so doing gave further guidance on how termination fees should be viewed under Delaware law.

Importantly, although the termination fee in *Cogent* amounted to only 3 percent of Cogent's \$943 million equity value, it was 6.6 percent of the company's \$430 million enterprise value.² The reason for this large disparity is that Cogent's balance sheet included \$513 million in cash and no debt. The *Cogent* court rejected the plaintiff's position that enterprise value is the proper measure against which to assess the termination fee, holding instead that Cogent's cash should be included for purposes of evaluating the reasonableness of the fee.

Under *Revlon, Inc. v. MacAndrews & Forbes Hldgs, Inc.*,³ when the sale of a company becomes inevitable (as when it enters into an agreement to be acquired), the board of directors has a duty to act in a way reasonably intended to maximize the sale price. As a result, deal protections that are preclusive of higher offers are generally not permissible. However, the Delaware courts have refused to establish hard-and-fast rules on the correct or maximum permissible size of a termination fee. Instead, the Delaware courts have insisted that each case be decided based on the particular facts and circumstances surrounding the transaction. Indeed, the Court in *In re Toys "R" Us, Inc. S'holder Litig.*⁴ noted that the reasonableness of a particular termination fee requires a "nuanced fact intensive inquiry." Nevertheless, valuable guidance can be gleaned from the existing case law:

RANGE OF PERMISSIBLE PERCENTAGE

- A termination fee of 3 percent is "generally reasonable."⁵
- Termination fees of 3.3 percent,⁶ 3.5 percent,⁷ 3.75 percent⁸ and 3.9 percent⁹ of equity value were specifically upheld under the facts and circumstances of the relevant cases.

¹ 2010 Del. Ch. LEXIS 203 (Del. Ch. Oct. 5, 2010).

² "Enterprise value" is generally thought of as the inherent value of the business, without regard to its capital structure, whereas "equity value" is the value of the company's outstanding stock, which can be derived by deducting the company's net debt (debt less cash) from enterprise value.

³ 506 A.2d 173 (Del. 1986).

⁴ 877A.2d 975, 1015 (Del. Ch. 2005).

⁵ *Cogent*, 2010 Del. Ch. LEXIS 203, at *33.

⁶ *In re MONY Grp. Inc.*, 852 A.2d 9 (Del. Ch. 2004).

⁷ *McMillan v. Intercargo Corp.*, 768 A.2d 492 (Del. Ch. 2000).

⁸ *Toys "R" Us*, 877 A.2d at 1021.

⁹ *In re Dollar Thrifty S'holder Litig.*, 2010 Del. Ch. LEXIS 192, at*29 (Del. Ch. Sept. 8, 2010).

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- A termination fee of 4.3 percent was found to be “a bit high” but not “likely to have deterred a [higher] bidder.”¹⁰
- On the other hand, a termination fee of 6.3 percent “certainly seems to stretch the definition of range of reasonableness and probably stretches the definition beyond its breaking point.”¹¹

KEY FACTS AND CIRCUMSTANCES

- Larger termination fees are more likely acceptable when the Board of Directors has fully shopped the company through a thoughtfully run, broad-based auction, and should be lower where the auction was less robust and the sale process would benefit from a post-signing market check.¹²
- Similarly, the termination fee percentage can be larger in smaller deals since the transaction costs are likely to be higher relative to the overall deal value.¹³
- Negotiations matter. A court recently noted, in upholding a termination fee of 3.9 percent (inclusive of expense reimbursement), that the fee was the result of a package that included a price increase and provisions providing greater deal certainty for the target from an antitrust perspective.¹⁴ Similarly, the *Cogent* court noted that the 3 percent fee had been negotiated down from 3M’s original request.¹⁵

EQUITY VS. ENTERPRISE VALUE

- For companies with large net cash positions, the target’s cash can be included for purposes of calculating the termination fee, whether the parties intend for the cash to remain on the balance sheet at closing¹⁶ or be paid out to shareholders in a special dividend.¹⁷
- Under appropriate circumstances, enterprise value could replace equity value as the proper measure against which to assess the termination fee, for example, where the target is highly leveraged and the buyer will refinance the company’s debt.¹⁸

In summary, under Delaware law, a buyer may base a termination fee on the metric that provides it with the best deal protection whether that amount is pegged to equity value or enterprise value. The decision in *Cogent* makes it clear that, going forward, the seller’s board of directors will continue to get significant deference in agreeing to a termination fee that it reasonably believes to be appropriate in the context of the whole transaction, so long as that amount does not appear to preclude a topping bid.

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¹⁰ *In re Topps Co. S'holder Litig.*, 926 A.2d 58, **70 (Del. Ch. 2007).

¹¹ *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, 1999 Del. Ch. LEXIS 202, at *5 (Del. Ch. Sept. 27, 1999).

¹² *In re Pennaco Energy, Inc. S'holder Litig.*, 787 A.2d 691, 707 (Del. Ch. 2001).

¹³ *Topps*, 926 A.2d at **79.

¹⁴ *Dollar Thrifty*, 2010 Del. Ch. LEXIS 192, at *30.

¹⁵ *Cogent*, 2010 Del. Ch. LEXIS 203, at *11.

¹⁶ *Id.* at *36.

¹⁷ *Dollar Thrifty*, 2010 Del. Ch. LEXIS 192, at *115.

¹⁸ *In re Lear Corp. S'holder Litig.*, 926 A.2d 94, 120 (Del. Ch. 2007).

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