M&A Break Fees:
US Litigation vs. UK Regulation

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The United States and the United Kingdom have well-developed economies and capital markets. They also share a legal tradition, including a liberal approach to economic activity. In some key areas of capital market governance, however, their legal systems formally diverge. One example – salient to merger and acquisition (M&A) academics – is the treatment of hostile bids (e.g., Armour & Skeel 2007). This paper analyzes another difference, one more routinely of importance to M&A practitioners: the treatment of "deal protection" – i.e., contracts that reduce the risk to a bidder of a competing bid, such as "break fees" paid by a target if acquired by a competing bidder. The UK caps such fees with a bright-line rule set by a regulatory body. In the US, courts review break fees in *ex post* litigation applying a standard developed over time in the common law tradition. This paper explores the effects of this formal contrast between regulation and litigation on the same behavior by two similar countries, using data on bids, fees, bid outcomes, and bid litigation to explore whether the formal difference matters in practice, and whether and how the two approaches to governance change and diverge over time.

Any comparison of law in two countries faces a serious and potentially misleading omitted variable problem, and one can only generalize so far about trade-offs between litigation and regulation from one law. Still, a comparison of deal protection in the UK and the US should yield some information. The two nations have similarly active M&A markets, with a large number of bids for public companies comprising 75% of worldwide bid volume (Rossi & Volpin 2004). They have similar corporate governance systems (e.g., Kraakman et al. 2009), with large companies and dispersed ownership (e.g., La Porta et al. 1999), which (as discussed below) generates the need for deal protection. And they have shared political, legal, and cultural traditions (U.S. State Department 2009), including M&A practitioners that work in both nations. The topic should also be of independent value to those who study or work in the M&A markets: deal protection is used regularly in friendly M&A, which is far more prevalent and may be more economically important than hostile bids.

Part I briefly reviews relevant literatures on (a) regulation and litigation, (b) the evolution of laws over time, and (c) deal protection, including the reasons deal protection contracts are used. Part I also briefly describes the legal treatment of break fees in the UK and the US, and conjectures why the nations have diverged in this aspect of capital markets governance. Part II summarizes data, including break fees, on large friendly control bids for non-financial targets drawn from Thomson regarding M&A activity, representing

~50% of total bid volume in the US and UK over the past 20 years. Trends in the size of break fees in the US and the UK are depicted against the backdrop of changes in regulation of break fees. Part III then relates break fee size to rates of deal competition and deal completion, two deal outcome variables that break fees are intended to affect. Univariate and multivariate results are presented, and the robustness of the findings is tested with alternative specifications. Part IV concludes with observations on trade-offs between litigation and regulation and the evolution of law more generally.

Part I. Prior Literature

I.A. Regulation and Litigation

A growing literature in economics and law recognizes and explores trade-offs in different modes of political governance of economic activity.[1] One mode, associated with classical liberalism, is for the state to assign clear property rights ex ante, permit private parties to write their own legal rules through contract, enforce those contracts through privately initiated lawsuits heard by independent courts, and otherwise refrain from interfering with production or trade. Because this mode of governance relies on court enforcement of property and contract rights, it is often identified as "***litigation***." A second mode, associated with political reactions to industrialization in the late 19th and 20th centuries, is for the state to establish expert regulatory agencies, subject to political control, which "regulate" economic activity through explicit ex ante controls, enforce those controls directly with criminal or civil penalties imposed by state-controlled enforcement agencies, subject to judicial oversight, and override, and forbid or control private contracts. This mode is often identified as "***regulation***."

The contrasts between litigation and regulation are thus various, including general content, the method by which law is created and enforced, and features of the institutions charged with lawmaking and enforcement. A common focus of contrast, however, is the timing of lawmaking and enforcement (e.g., Shavell 1984a,b; Schwartzstein & Shleifer 2009). Regulation specifies and enforces entitlements in detail *ex ante*, before activities occur, so (if perfect) violations are avoided. Litigation relies on private parties to sue for money in court *ex post*, after activities and potential legal violations have occurred. If parties are judgment proof, for example, *ex ante* specification and enforcement may be beneficial (Shavell 1984a,b, 1993, Summers 1983). But courts can grant injunctions as well as award damages, and many economic harms are not so large as to cause insolvency. If economic activities have positive externalities and both *ex ante* regulations and *ex post* court decisions are prone to error, then regulation can improve welfare by eliminating or reducing the risk of mistaken ex post liability and so inducing socially beneficial activities, such as drug research (e.g., Schwartzstein & Shleifer 2009). But much regulation has been developed to address negative externalities, rather than positive

[1] One can also contrast socialism, with state ownership of the means of production and/or trade, as with the U.S. Postal Service; and anarchy, with no clear specification of property rights, as with second-hand cigarette smoke, or no effective state enforcement of regulations or contract rights, as with trade in sex or drugs.

ones, and spans domains of activity where the risk and potential harm of error in law enforcement varies significantly.

Given rational expectations, the timing of lawmaking matters because agents can better estimate their entitlements under regulation than under litigation. If they could perfectly foresee how courts would apply law to given facts, or if their ability to predict application of law to their behavior was invariant as between regulation and litigation, there would be no difference between litigation and regulation as a result of the timing of lawmaking and enforcement.[2] Research on litigation and regulation conceived this way is related to a separate line of legal research that also describes trade-offs between *ex ante* specification of law ("rules") and *ex post* application of general laws to specific facts ("standards") (Ehrlich & Posner 1974). That literature recognizes that courts sometimes develop "rules" that function much as do regulations (e.g., contracts cannot be enforced against persons under the age of 18), and emphasizes that such rules specified ex ante – whether by courts *or* regulatory agencies -- increase certainty and reduce the costs of legal advice and adjudication ex post, but are more costly to enact (Kaplow 1992) and more frequently lead to specific case outcomes that reduce welfare, by being both over- and under-inclusive (Kennedy 1986), particularly when they will apply over a broad range of behaviors over a long period of time, or where lawmakers' information is limited (Sunstein 1995).

Another use of "regulation" is relevant in the context of corporate and securities laws governing M&A. Legal scholars have long argued over whether those bodies of law are or should be mandatory ("regulatory") or optional ("default" rules) (e.g., Bebchuk 1989). Should use of the corporate form -- or the raising of capital from dispersed investors -- trigger laws that can be freely tailored through the corporate charter or bylaws or contract, or should they be binding? And if binding, should they be binding with respect to issuers other than fraud? Laws that are "regulatory" in this sense are not necessarily clear *ex ante* rules, and they may require *ex post* litigation to clarify their meaning as well as for enforcement – in effect, the content of key M&A contracts, including the risk of litigation, may be imposed by regulation.

Legal scholars tend to classify laws as mandatory or default formally, based on whether they expressly permit companies to "opt out" of their provisions. But many laws relevant to M&A that are, on their face, "regulatory" in this sense can, with some ingenuity and

[2] Other differences between the two general modes of lawmaking, such as expertise or political control of lawmakers or law enforcers, might still matter. If judges are generalists, and regulatory agencies specialists, for example, the latter may have expertise that may be beneficial (Landis 1938, Glaeser, Johnson & Shleifer 2001). But courts can be (and often are) specialized (e.g., Revesz 1990, who discusses 12 specialized Federal courts in the US, and Dreyfuss 1995, who discusses the Delaware Chancery Court, which specializes in business litigation). If regulatory agencies are subject to more and courts less political control, the latter could more optimally address harms imposed by politically powerful agents on politically weak agents (Pace 2007; Cook 2002). But in the US, at least, many regulatory agencies (e.g., the Federal Reserve Board) are arguably subject to weaker political control than judges, who are elected in most states Rottman (2000), and precisely the opposite argument has been made in favor of regulation on the ground that judges or law enforcers required to impose large *ex post* fines may be more vulnerable to persuasion or bribery (Becker & Stigler 1974, Glaeser & Shleifer 2003).

effort, be "contracted around."[3] But "opt outs" of such core elements of corporate law are rare US, possibly because of transaction costs, exacerbated by network effects (Coates 1999). In practice, laws that are formally mandatory may not bind, and laws that are formally default rules may bind. Key aspects of M&A law are, in practice, "regulatory" in the sense specified above – there are clear ex ante rules that typically structure the deal process. They are not "regulatory" in a formal sense, in that they can be contracted around. But in practice, they rarely are.

An important set of examples for US M&A practice arises from the "fiduciary duties" applicable to corporate directors and officers. Fiduciary duty law is widely thought to represent an attempt to supplement private contract not for any of the reasons summarized above for regulation, but because detailed specification of contracts ex ante is too expensive or in some cases impossible, whether because of imperfect information, collective action problems, or both. Fiduciary duty law is "regulatory" in the sense that, in general terms, private parties cannot opt out of it – it is binding on them whether they include it in their contracts or not, and often has a moral flavor similar to criminal laws. But it is enforced through private litigation *ex post* in courts; it remains relatively unspecified in detailed content until applied to specific facts (is a set of "standards"); and, in some particulars, it may be contracted around (e.g., Coates 1999). An overly strong distinction between litigation and regulation as modes of lawmaking may obscure the fact that many laws partake of both.

I.B. Evolution of Laws Over Time

Overlapping with the literature contrasting litigation and regulation is research exploring the degree to which particular kinds of laws change of time. Here, the contrast is made between "civil law" – codes and statutes that remain relatively unchanged over time – and "common law" – bodies of judicial decisions accompanied by some explanation of the principles used to reach specific outcomes that provide a degree (but only a degree) of guidance about future cases. The general relationship to the bodies of research summarized above should be apparent. Civil law is (the output of) regulation; it consists of many rules; it changes rarely. Common law is (the output of) litigation; it consists of many standards, made into rules only for purposes of each case as it happens; it changes adapts routinely, as every case presents at least some relevant facts that may distinguish it from prior cases.

One line of research explores whether and how a common law system would tend towards efficiency over time and, implicitly, whether and how the common law would evolve "rules" out of "standards" (as is commonly asserted or assumed in much legal scholarship, e.g., Kaplow 1992). Posner 1973 claimed appellate judges have personal or

[3] For example, every US state provides that, with board approval, a majority of shareholders may approve a merger with another corporation, and in the merger dissenting shareholders will have a choice of accepting the merger consideration or cash at a "fair value" set ex post by a court. In effect, shareholders can have their shares converted into cash by majority vote through merger. Coates 1999 shows that the risk of such ex post litigation can be eliminated by contract. Further, the ability of a majority of shareholders to force through a merger could be eliminated by contract -- a corporate charter could, for example, require unanimous shareholder approval of a merger.

career incentives to maximize efficiency. Rubin 1977 proposed inefficient outcomes are more likely to be challenged in court, resulting in litigation that over time produces efficient laws, even if judges are unaware they are doing so. Llewellyn 1951 and Posner 2005 reasoned that even with biased judges the common law would evolve towards efficiency because it involves sequential decision-making of judges with diverse preferences, which would cancel out over time, although this assumes judges respect precedent, to some extent, else there would be no trend over time. Gennaioli & Shleifer 2007 suggest that appellate courts in a common law system tend towards efficiency because they preserve information by distinguishing current cases from prior decisions.

Other conjectures about the evolution of law can be found in the literatures reviewed above. Sunstein 1995 claims that a system of rules entails "no rapid changes in the content of law," consistent with a common view that civil law is less flexible or adaptable than common law, and that regulation tends towards sclerosis. Rajan & Zingales 1999 argue that civil law countries (i.e., countries that rely on regulatory agencies subject to political controls as their primary means of lawmaking) can undergo more rapid and transformative legal changes in response to changes in private interests, than can the common law. This claim could be consistent with claims about regulatory sclerosis if, over periods of time, private interests remain stable, producing little change in a regulatory system, but occasionally, in response to factor, technological or unrelated political shocks, private interests shift suddenly, leading to regulatory change that is more rapid and significant than could occur through litigation in a common law system. Kennedy 1986 suggests reasons (and offers some qualitative evidence) that rules and standards may cycle, evolving into the other over time: rules evolve into standards as the welfare loss commanded by a rule in a given case will induce a court to invent an exception, with the exceptions eventually swallowing the rule; conversely, standards induce rules, as private parties lobby for (or persuade courts to adopt) rules to assist them in planning.

Niblett et al. 2009 provide one of the few empirical tests of some of these claims by tracking the evolution of one aspect of US tort law (the economic loss rule) from 1970 to 2005 and find that while the law did appear to converge towards one version of the rule in the first 25 years of their sample period, courts have begun to deviate and splinter in their approach to the rule – i.e., the law did not converge to any stable resting point. This paper attempts to provide another empirical test of theories of how common law evolves over time, in a different domain.

I.C. Deal Protection and Break Fees

In both the UK and the US, M&A involving public company targets face a law-derived risk of non-completion: (1) the law requires target shareholders to approve or accept a bid, either by tendering or voting; (2) compliance with disclosure and other laws governing the process of obtaining target shareholder tenders or votes entails delay, ranging from a minimum of 30 days up to six months in some situations; and (3) target shareholders may decide not to accept or approve a bid for any reason, including a third-party bid that emerges after agreements for an initial bid are signed. In effect, an M&A

agreement or bid gives shareholders of a public target an option to accept the bid, and does not effectively bind the target or its shareholders to the bid, even if approved by the target's ordinary agents (i.e., its board or officers).

Deal protection contracts, including break fees, have emerged as a second-best way for bidders to protect their reliance interests in pursuing a bid for a public target. Even if they are unable to acquire the target, they can at least get paid a fee, if their bid is rejected and (typically) if the target is acquired by a competing bidder. Unlike the underlying bid, the target's promise to pay a break fee (often included in the deal agreement) is not generally subject to shareholder approval, in either the US or the UK. Targets, in turn, agree to break fees – even though they may reduce competitive bids – because they encourage bidder participation in the face of valuation uncertainty and bidding costs, including significant and difficulty-to-quantify opportunity costs, and compensate a bidder for the inevitable release of valuable information to third parties (including potential competitors) upon the announcement of a bid for the target. Targets may also use break fees to control a sales process where the failure of that process to produce a completed deal can harm the target. Alternatively, target managers may agree to break fees to favor a bidder out of personal interests – better jobs after the deal, higher severance pay, or other private benefits.

Prior literature focused on break fees and other forms of deal protection can be found in both legal academic writing and in finance scholarship. In the US, legal scholars have long debated whether and when break fees can represent a breach of the duty of loyalty of a target's board of directors. Prominent theoretical articles in the legal literature include Schwartz 1986, who suggested a ban on break fees, to encourage bid competition; Ayres 1990, who noted that break fees reduce an initial bidders' valuation of a target as well as competing bidders, and would reduce welfare only if they deterred competing bids and not if a competing bidder in fact emerged; Fraidin & Hanson 1994, who applied the Coase theorem to argue for a permissive attitude towards break fees; and Kahan & Klausner 1996, who argued that courts should be more permissive towards break fees that induce an initial bid, and more skeptical of those granted to subsequent bidders, particularly when solicited by target managers, whose choice of bidder may be biased by agency costs.

Empirical research on break fees was initiated by Coates & Subramanian 2001, who studied break fees and other forms of deal protection granted by US targets in friendly bids for control greater than $50 million in value in the period 1988 to 1999. They found that break fee size was dispersed and grew (again, non-monotonically) throughout the period, ranging from 1% (25th percentile) to 3% (75th percentile) in 1988 and from 2% (25th) to 4% (75th) in 1999, consistent with a potential "Lake Woebegone effect," in which bidders sought a fee that was slightly larger than the average fee in a recent period sample, producing ever-increasing fees.[4] They also found that fee size correlated with

[4] Boone & Mulherin 2006 find (and Andre et al. 2007 confirm) that Thomson's data on break fee incidence is biased in several respects: first, there is a general underreporting of fees and other forms of deal protection, relative to what is revealed by a careful review of SEC filings; second, there is a greater underreporting earlier in time, creating the spurious impression of time trends in fee incidence; and third,

court decisions, including 1994 and 1997 Delaware Supreme Court decisions in *Paramount* and *Brazen*, and with other bid characteristics, including larger bid size and the use of a tender offer by the bidder. They found, finally, in both univariate and multivariate tests, that the fact and size of break fees correlated with completion rates, both in general and conditional on publicly reported bid competition.

Subsequent research, using US data 1988 to 2000, confirmed their findings, and also found that break fees reduce the incidence of subsequent publicly reported competing bids, and (using a simultaneous equations system) that deal premiums were higher where targets agreed to pay break fees, consistent with the hypothesis that – at least at the fee levels observed in the sample period, and conditional on judicial scrutiny, discussed below – break fees were on average effective both at reducing bid competition and beneficial for target shareholders (Officer 2003, Bates & Lemmon 2001; see also Burch 2001, who examines deal protection in the form of stock options). Empirical research on break fees has also been reported for Canada (Andre et al. 2007), which reaches similar general conclusions, and for Australia (Chapple et al. 2007), which finds that break fees in Australia – which must comply with a bright-line rule similar to the one imposed in the UK – appear actually to correlate ***inversely*** with bid completion, and with bid premiums. No studies appear to have been done of break fees in the UK, and none compares break fee size, or the effects of break fees between the UK and the US.

I.D. Legal Treatment of Break Fees

Why is deal protection regulated (or the subject of a special type of litigation)? There are three related justifications for having special laws for break fees. First, they can deter bids, reduce competition, and reduce welfare by allowing the target to be transferred to a lower-valuing bidder. Normally, however, the law does not compel sellers of assets to sell to the buyer that will pay the most – having assigned a property right in a given asset, the law presumes that the owner of the asset will be best positioned to choose a buyer, taking into consideration all relevant factors, including value that may not be reflected in the sale price (e.g., a sale to family members, to neighbors, to a repeat customer, etc.). But for public targets, the "owners" are dispersed shareholders, who cannot effectively represent themselves in the sales process. Target managers effectively choose among bidders in the first instance, subject to shareholder approval. Target manager preferences over bidders, moreover, can be expected to systematically differ from those of target shareholders. Traditional fiduciary duty law would thus constrain, to some extent, target managers' ability to use break fees to favor one bidder over another, absent a justification, particularly if the target managers had some evident tangible interest in the choice, such as a better job or severance package. Third and finally, there is a broader justification rooted in the basic structure of corporate law common to the UK and its former colonies, which is that a fee cannot be so large as to essentially eliminate the

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there is greater underreporting for smaller bids, creating the spurious impression of a relationship between toeholds and break fees. Since these biases emerge from underreporting by Thomson, they should not affect data on fee size, since such data is only available where Thomson reports fee data. They also confirm the finding, reported in Coates & Subramanian 2001, that fee incidence increased significantly after the 1994 Delaware Supreme Court decision in *Paramount*.

option target shareholders have to accept or reject the bid. Put differently, even if there is no specific concern about target managers in the context of a particular bid, a law permitting any and all break fees to be enforced would crucially undermine more generally laws requiring shareholder consent for sale of the company. Those more general laws can be justified either on contract grounds – they were part of the bargain by virtue of being part of corporate law at the time investors purchased stock in a company – and on efficiency grounds – shareholder approval or consent requirements constrain agency costs in general, even if they are unnecessary or even inefficiently costly for a given company with given managers in the context of a given bid. For any or all of these reasons, the law in each of the US and the UK constrains break fees. But it does so differently in each nation.

I.D.1. UK Regulation of Break Fees

In the UK, break fees are constrained in theory by three sets of laws, but in practice only two are binding, and both have identical effects (Davies et al. 2004; Montgomery et al. 2005). The Takeover Code limits break fees to one percent of the value of the bid.[5] That Code was originally a set of rules self-imposed voluntarily by major institutional participants in the City, including representatives of the Bank of England, the London Stock Exchange (LSE), leading merchant banks, and organizations representing institutional investors, and is now statutorily binding on all tender offers for public companies in the UK, by virtue of the UK's implementation of the EU-wide Takeover Directive.[6] Prior to 2006, the Takeover Code did not formally have the force of law, but was practically binding (Armour & Skeel 2007; Tarbert 2003), in part because UK courts deferred to its judgments because they recognized that the UK's formal regulatory bodies (the Department of Trade and Industry and the Bank of England) had sponsored its formation.[7] The direct sanction for flouting its requirements was expulsion from the LSE and trade organizations representing institutional investors, disinvestment by the British institutional investor community (who were required by the terms of the Code to divest from anyone breaking the Code), and an inability to obtain services or other assistance from others subject to the Code. In essence, Code enforcement piggy-backed on private

[5] The Panel on Takeovers and Mergers, The Takeover Code § 21.2.

[6] European Parliament and Council Directive 2004/05, 2004 O.J. (L142) 12 (EC), art. 4 (supervisory authorities may include private bodies recognised by national law, such as the Takeover Panel), 9 (target board obligations include not taking frustrating actions, including limits on break fees); The Takeovers Directive (Interim Implementation) Regulations 2006, 2006 S.I. 2006/1183 (Eng.), available at www.opsi.gov.uk/SI/si2006/20061183.htm (transitional provisions); Companies Act, 2006, c. 46, §§942-65 (Eng.), statute giving Takeover Panel authority to write Takeover Code, and its Hearing Committee authority to give binding rulings on its application).

[7] Regina v. Panel on Take-overs and Mergers, Ex parte Datafin Plc., 1987 Q.B. 815, 838-39 (C.A.) (The Panel's "source of power is only partly based upon moral persuasion and the assent of institutions and their members, the bottom line being the statutory powers exercised by the Department of Trade and Industry and the Bank of England. In this context I should be very disappointed if the courts could not recognize the realities of executive power and allowed their vision to be clouded by the subtlety and sometimes complexity of the way in which it can be exerted.").

organizations and relationships that would be considered essential for ongoing business activities in the UK.

Currently, the Takeover Panel, responsible for interpreting and resolving disputes under the Takeover Code, includes members nominated by trade organizations of insurance companies, investment companies, investment managers and brokers, commercial and investment bankers, industrial companies, accountants, and pension funds, and those members also constitute a majority of the members of the Hearing Committee, which hears disputes and imposes sanctions under the Code.[8] It is thus an "expert" regulatory body. But as long as it retains its public, bright-line character and is backed by the threat of significant sanctions, UK law on break fees functions as a self-enforcing bright-line rule that requires no ongoing expertise. (In principle, the Takeover Panel could raise or lower the cap over time, in response to changing market conditions or evidence regarding the welfare or other effects of break fees, but they have not done so in the 10 years since the rule was first formally adopted.[9] Few if any disputes concerning the rule's application to conventional break fees, and the rule can only be deviated from with advance permission of that same body, which reportedly they rarely grant. (These statements are consistent with the data discussed in Part II below.)

A second law – the Company Code – has long forbidden public companies in the UK from providing "financial assistance" to anyone purchasing their shares, including in the context of a takeover bid.[10] "Financial assistance" for this purpose includes any contingent payment to the bidder by the target, with certain exceptions. Break fees are covered, unless they are less than one percent of the bid value. Violations of the law could result in civil and even criminal penalties for any officer or director of the target that approved the violation. Thus, even if a bidder would be prepared to endure expulsion from the UK financial community in order to obtain a break fee larger than one percent, targets risk significant sanctions if they agree. Agreements for such fees would also be unenforceable in UK courts, making it risky for a bidder to rely on an agreement for such a fee, even if a target were willing to risk sanctions. Unlike the Takeover Code, the Company Code was adopted as a general statute by Parliament, and to that degree differs from the modal form of regulation described above. But as with the Takeover Code, the Company Code provisions as applied to break fees function as bright-line rules, with the ex ante character of regulation, and generate few disputes and little litigation.

Third, and unimportantly in the UK, there are general fiduciary duty obligations, enforced in a common law fashion by the UK courts. Because the Takeover Code and Company Code provisions described above effectively rule out legally controversial break fees, no competing bidders have sought an injunction or other judicial remedy as a result of a break fee on fiduciary duty grounds. In short, *ex ante* bright-line UK

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[8] See http://www.thetakeoverpanel.org.uk/structure/panel-membership.

[9] Takeover Panel, Inducement Fees, Panel Statement 1999/10 (7/16/1999), available at http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/12/1999-10.pdf.

[10] Companies Act 2006 (c. 46), Part 18, Chapter 2; Companies Act 1985 §§ 151-158.

regulation of break fees by an expert body, supplemented by a bright-line statute, has crowded out break fee litigation and the use of *ex post* standards in practice, even if they remain formally available.

I.D.2. US Law on Break Fees

In the US, there is no equivalent to the UK Takeover Code or the statutory UK ban on "financial assistance." Nor are break fees constrained by Federal law. Instead, the only legal constraints are the general fiduciary duties imposed on target directors and officers by state corporate law enforced through litigation (Coates & Subramanian 2001). Target shareholders – including a competing bidder that purchases a single share of the target – have standing to sue in court on the ground that the agreement to pay a break fee was disloyal, grossly negligent, or both. While courts typically defer to the "business judgment" of a company's board in such cases, if the bidder can plausibly argue that the fee was designed to favor incumbent managers, it will often be able to get a court to scrutinize the facts surrounding the fee agreement. One relevant consideration, but only one, will be the size of the fee. Other factors, such as the target board's plausible interests in favoring a particular bidder, the information they had at the time they granted the fee, the process that preceded the grant of the fee provision, and the size of comparable fees in comparable transactions, will all generally be considered by the reviewing court, in a typically fact-intensive fiduciary duty case.[11]

Because there is no bright-line rule setting a maximum amount for break fees in the US, bidders or target shareholders unhappy with a given fee must seek to attack it *ex post*, in court, without any assurance as to the outcome. Bidders that want break fees must negotiate for them without knowing precisely how large the fee can be without risking a court finding that it represents a breach of the target's fiduciary's duties. (Courts view a bidder as participating in any violation represented by an agreed-upon fee, so a bidder may not claim an entitlement arising from a breach by the target's directors.[12])

The courts reviewing the claims have "general jurisdiction" in most states – they do not specialize in M&A. In Delaware, the leading US jurisdiction for M&A law, the reviewing court will be the Court of Chancery, which specializes to a large extent in corporate law cases, including M&A and deal protection. While there is no requirement that plaintiffs sue in Delaware when a Delaware target's directors are alleged to have breached their fiduciary duties, the data presented in Part IV below show that specialized Delaware courts retains a "market share" at least equal to Delaware's share of public companies generally. On mode of regulation, then, the US thus uses a part-hybrid model: *ex post* review through litigation in courts which, 60% of the time, have specialized knowledge.

[11] E.g., Louisiana Municipal Police Employees' Retirement System v. Crawford, 918 A.2d 1172, Del.Ch. (Lamb, V.C.), February 23, 2007 (No. Civ. A. 2635-N, Civ. A. 2663-N) (listing a number of factors to be considered in evaluating break fees).

[12] E.g., Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 55 (Del. 1994).

I.D.3. Why the Divergence?

Why have the US and the UK diverged in their treatment of break fees? In both countries, law on break fees emerges from the law on hostile takeovers, despite the relatively minor role that hostile takeovers now play in the US. In the UK, break fees were attacked in the mid-1980s as a type of "frustrating action" by a target that was prohibited in general terms by the Takeover Code in force then and now. In the US, break fees were attacked as violations of the target's fiduciary duties, which are given heightened scrutiny by courts in the takeover context. Both countries adapted their pre-existing systems for governing hostile takeovers and target responses to the growth in the use of break fees, despite the fact that most break fees are not used primarily in the context of hostile takeovers.

That explanation, of course, only begs the question: why do the UK and the US approach hostile takeovers differently? Part of that history has been told by Armour & Skeel 2007, drawing on interviews and newspaper accounts. Here is a summary: When hostile bids emerged in the 1950s, they received negative press, but opinion was insufficient to result in legislation or regulation, leaving them to the courts. Targets began to use defenses that were controversial for interfering with what were perceived as shareholder rights, but not so extreme as to lead courts to set aside their traditional reluctance to interfere with the business judgment of corporate boards. In the UK, institutional shareholders were more significant than in the US, and more organized, facing lower costs for collective political action (Olson 1965). Legislative intervention posed political risks extending beyond M&A to economic regulation generally, so institutions and the financial community preempted Parliament by developing a self-regulatory body, with the implicit backing of the UK government. In the US, by contrast, corporate managers were more politically powerful than shareholders, and the only Federal legislation to be proposed (the Williams Act) was intended to restrict takeovers, not takeover defenses. Although a pre-existing regulatory agency (the SEC) was able to lobby for a more neutral, disclosure-oriented takeover statute, defenses were largely left to the states to govern with *ex post* litigation.

This capsule comparative history of takeover governance suggests the contrast between the UK's regulatory approach and the US's litigation approach is less stark than in the narrow case of break fees. That is because the UK Code, while bright-line with respect to break fees, is full of standards as applied to takeovers generally, and has generated a substantial body of litigation. But most of this "litigation" is of a different character than true in US courts, in three respects. First, it does not involve lawyers. Second, partly due to not involving lawyers, it is faster. Third, partly due to being faster, it takes place *ex ante*, before a given action that might create a conflict occurs – bidders and targets go to the Panel to ask permission for a given action, and the Panel decides whether they can. In essence, the UK has in general formalized a means to combine the benefits of certainty that come from ex ante regulation with the benefits of tailoring that come from *ex post* standards. But as applied to break fees, they have chosen a much starker form of *ex ante* regulation.

Part II. Data on Break Fees in the US and the UK

II.A. Sample Description

The sample is drawn from Thomson Financial's M&A Database. All bids for UK or US targets in the time period 1989 through 2008 are initially sampled (n= 17,977). Because bid techniques (including deal protection) vary by deal size (see Coates & Subramanian 2001), because deal size may vary between the UK and the US, and because bid size has varied over time, the sample is then constrained to consist of bids over a $1 billion, which is roughly the 90th percentile of bid size in 1989 – this paper refers to these bids as "large bids" for convenience. (None of the qualitative findings reported below depend on the precise size cut-off.) This produces a total of 5,171 bids.

Bids that are reported by Thomson as still pending – i.e., bids with no effective date or withdrawal date – are dropped, leaving 4,404 bids. Of those, Thomson classifies 865 as "hostile," meaning the target publicly resisted the bid. Because a target's consent is required to obtain standard deal protection, deal protection is less likely to be found in hostile bids, and they are dropped.[13] Of the remaining bids, 194 bids sought less than a controlling interest, and are accordingly dropped. Because banks and other financial institutions are generally cash- and capital-constrained, making conventional cash break fees difficult or impossible to pay (see Coates and Subramanian 2001 for a discussion and evidence in the US context); while economic substitutes are available (e.g., stock or asset options), they are regulated differently than break fees, at least in the US. Bids for targets with SIC codes 6000-6999 (n=766) are dropped.

These procedures leave a total of 2,579 bids. Of those, Thomson reports stock price and premium data for only 1,346, consisting of 209 bids for UK companies and 1,136 bids for US companies. This subsample is the focus of the remaining analysis,[14] and represents ~50% of the total friendly control bid volume for non-financial targets in the US and UK over the past 20 years.

II.B. Summary Data and Simple Comparisons of Large Bids in the US and the UK

As shown in Table 1, 88% of large US and UK bids were completed, the rest withdrawn. Average (median) bid size was $4.9 billion ($2.1 billion). Mean (median) duration of a completed bid was 145 (114) days. Bids were at an average (median) premium over the prior day's target stock price of 30% (26%). Break fees – again, including US and UK bids – were used in 70% of bids,[15] and were an average (median) of 2.6% (2.7%) of deal

[13] There are, in fact, more hostile bids as a share of large bids in the UK (7% of the broader sample of large bids) than in the US (3%, p-value < .01). But as noted at the outset, there are many more friendly deals in each country. Break fees are also much less common in the dropped hostile bids (13%) than in the retained friendly bids (37%). Rossi & Volpin 2007 report fewer hostile bids in the UK (4.4% of listed firms versus 6.4% in the US) for a sample that includes smaller bids.

[14] More UK bids lack premium data (58%) than US bids (51%), but the basic results discussed below regarding incidence and size of break fees, and their relationships with bid completion and bid competition, are not qualitatively affected by retaining all large non-pending friendly control bids for non-bank targets.
[15] But see Boone & Mulherin 2006 on underreporting of break fees in Thomson's database.

size. In nominal dollars, the average break fee was $124 million; the largest was $3.9 billion.

Bid size between the two nations was similar: $4.7 billion in the UK, on average, versus $5.0 billion in the US. Bids using stock consideration were larger than cash bids, but this was true in both nations. Yet, as reflected in Table 1, break fees were used significantly less often and were significantly smaller in the UK than in the US. In nominal dollars, the average agreed-upon UK fee was $41 million, a third that of the average US break fee, at $128 million; the largest agreed-upon fee was $212 million, in the 2007 buyout of Alliance Boots in 5% of the largest US fee, at $3.9 billion, in the 2000 stock merger of Time-Warner and AOL. In withdrawn bids, where the fees may have been actually paid, the average fee in the UK was $25 million, 15% of the average paid fee of $184 million in the US; the largest paid fee in the UK subsample was a mere $35 million, in the 2000 acquisition of Lasmo by Amerada Hess, compared to the largest US fee, $1.8 billion paid in the 2000 acquisition of Warner-Lambert by Pfizer. In the US, 95% of break fees were greater than one percent, the maximum for the UK.

Table 1.

Summary Statistics, All Bids and US vs. UK Bids Over $1 billion, 1989-2008

	Mean for all bids (n=1346)	Mean for UK bids (n=209)	Mean for US bids (n=1137)	p-value (US vs. UK)
% sought in bid	98.5	97.3%	98.7%	0.01
Bid value ($mm)	4.9	4.7	5.0	0.72
% bid premium over 1-day prior market price	29.8	30.0	29.8	0.91
% with break fees[6]	70.4	18.7	70.3	0.00
Break fee as % of bid value	2.6	0.9	2.6	0.00
% using tender offer	26.9	72.2	18.6	0.00
% cash bids	56.7	65.1	55.1	0.01
% stock bids	28.0	5.3	32.1	0.00
% cross-border	19.9	36.8	16.9	0.00
Duration of completed bids in days	145	128	148	0.02

US bids took longer to complete than UK bids. The reason for the timing difference has to do with the interaction of law – stock deals require a more lengthy regulatory process in both nations, due to disclosure and registration requirements – and bid financing, which is weighted more towards cash in the UK than in the US. Specifically, UK bids are most frequently for all cash (65%) than for all stock (5%) or for other securities or a blend of deal currencies (30%). While large US bids are also most commonly for all cash (55%), they are more frequently for stock (32%) than in the UK, with the rest for other securities or a blend of deal currencies (13%). Each pair-wise difference is statistically significant at a p-value of <.01. As shown in Table 2, cash bids take roughly the same amount of time in both countries.

Table 2. Summary Statistics, Cash Bids in US vs. Cash Bids in UK, 1989-2008			
	Mean for UK cash bids (n=209)	Mean for US cash bids (n=1137)	p-value (US vs. UK cash bids)
% sought in bid	96.4%	98.4%	0.00
Bid value ($mm)	4.1	4.2	0.93
% bid premium over 1-day prior market price	29.8	29.9	0.96
% with break fees[6]	26.4	80.3	0.00
Break fee as % of bid value	0.9	2.7	0.00
% using tender offer	72.1	28.6	0.00
% cross-border	35.3	21.3	0.00
Duration of completed bids in days	126	133	0.44

II.C. Trends in Break Fee Size

Trends in the size of break fees in the US and the UK are presented in Table 3. As previously reported in Coates & Subramanian 2001 (for a sample including smaller deals than reported on in this paper), break fees increased over the course of the 1990s in the US. However, any trend in US break fees in large deals appears to have moderated in the 2000s. As a more formal test, break fee size as a percent of bid value is regressed against the bid announcement date, and against bid announcement date, a dummy indicating that the year of announcement is after 1999, and the interaction of announcement date and the year 1999. In both regressions (unreported), bid announcement date correlates strongly with break fee size, but the signs on post-1999 and date*1999 interaction are negative and statistically insignificant.

By comparison, there is no marked trend in break fees in the UK. Thomson only reports break fees in UK bids starting in 1999, but break fees already are clustering near the legal cap of 1% as early as 2000, and remain there throughout the sample period. While break fees were used on occasion in the UK prior to the 2000s, they were sufficiently suspect – viewed as potentially a type of "frustrating action" barred by the UK Takeover Code – that they did not occur frequently in the 1990s, and only began to appear regularly after they were implicitly legitimized by the adoption of the 1% cap in 1999.[16] (In only one year – 2005 – are there any reported break fees in excess of 1.0%, and that one outlier is an erroneous datum in Thomson, which lists PetroKhazakhstan as a UK target, when it fact it was Canadian.) Of break fees reported in the UK, over 60% fall between 0.9% and 1.0% of bid value; in the US, only 2% fall in that range. In unreported regressions, there

[16] This statement is based less on the data in Thomson, which is unreliable on break fee incidence, and more on statements in practitioner commentary on break fees (Davies et al. 2004, Montgomery et al. 2005, Tarbert 2003), and the general absence of such commentary prior to 2000. Technically, break fees in deals structured not as tender offers but amalgamations or restructurings would not be subject to the Takeover Code, but the Code's approval of 1% fees seems to have increased used of such fees in that types of deals as well, as reflected in the Company Code's adoption of 1% as a safe-harbor for purposes of the ban on financial assistance. See Davies et al. 2004.

is no relationship of break fee size on bid announcement date over any part of the sample period.

Table 3. Trends in Break Fee Size, US vs. UK, 1989-2008				
	UK		US	
	Mean	Median	Mean	Median
1989	--	--	1.5%	1.0%
1990	--	--	2.6%	2.6%
1991	--	--	3.0%	3.0%
1992	--	--	1.6%	1.2%
1993	--	--	2.1%	2.1%
1994	--	--	2.3%	2.2%
1995	--	--	2.2%	2.4%
1996	--	--	2.5%	2.5%
1997	--	--	2.5%	2.5%
1998	--	--	2.4%	2.5%
1999	0.7%	0.7%	2.4%	2.6%
2000	0.9%	0.9%	3.0%	2.8%
2001	--	--	2.7%	2.7%
2002	0.4%	0.4%	2.8%	2.8%
2003	--	--	3.0%	3.2%
2004	1.0%	1.0%	2.8%	3.0%
2005	1.5% (0.8%)	1.0% (0.8%)	2.6%	2.8%
2006	0.7%	0.8%	2.8%	2.9%
2007	1.0%	1.0%	2.7%	2.9%
2008	1.0%	1.0%	2.9%	2.8%
-- = no observed break fees; for 2005, the UK fee statistics are listed as derived directly from Thomson, and in parentheses as corrected after dropping a misclassified target (see text)				

Table 4 depicts trends in variation of break fee size in the UK and in the US in available years, showing the inter-quartile difference (i.e., the 75th percentile sized fee for the year less the 25th percentile sized fee) and the annual standard deviation in break fee size, as a percentage of bid value. In all years but 2005, both measures of variation of fee size are more than double for the US than for the UK, and sometimes much larger, than its counterpart in the UK. After dropping the misclassified deal discussed above, the same is true for 2005. There do not seem to be any trends in the variation in the US data: despite years of experience, thousands of deals, and hundreds of lawsuits (discussed below), there remains as much variation in observed break fee size in the early 1990s as there is in the late 2000s.

Table 4. Trends in Variation in Break Fee Size, US vs. UK, 1989-2008				
	Interquartile Range of Break Fee Size		Standard Deviation of Break Fee Size	
	UK	US	UK	US
1989		0.01066	--	0.00752
1990		0.02620	--	--
1991		0.00000	--	0.01525
1992		0.01965	--	0.01563
1993		0.01536	--	0.00820
1994		0.00980	--	0.00895
1995		0.00738	--	0.00736
1996		0.01055	--	0.00846
1997		0.00916	--	0.00938
1998		0.00995	--	0.00877
1999	0.00000	0.01063	--	0.00932
2000	0.00000	0.00878	--	0.01194
2001	0.00000	0.01258	--	0.00931
2002	0.00000	0.01151	--	0.00756
2003	0.00000	0.01163	--	0.01179
2004	0.00069	0.01314	0.00048	0.00809
2005	0.02523 (0.00556)	0.01062	0.01325 (0.00393)	0.00766
2006	0.00435	0.00815	0.00314	0.00699
2007	0.00060	0.00940	0.00247	0.00812
2008	0.00158	0.00951	0.00087	0.00850
-- = insufficient observations; for 2005, the UK fee statistics are listed as derived directly from Thomson, and in parentheses as corrected after dropping a misclassified target (see text)				

As an alternative measure, break fee size was regressed separately against industry controls (one-digit SIC codes) and the observed deal characteristics used in the multivariate regressions described below (use of cash consideration, tender offer, cross-border deals, and bid value). Given the paucity of reported break fees in the UK prior to 2000, this regression was run for the subsample consisting of years after 1999, although the qualitative result is the same without this restriction. For the UK, this (unreported) regression has an R-squared of 26%; for the US, it is only 6%.

In litigation, this variation in the US fees means that defendant fiduciaries will truthfully be able to list a number of billion-dollar bids with fees well above the average – eight over 5% since 2000 in this sample, for example. Since break fees decrease as a percentage of bid size as bid size increases in this and other samples, a larger set of examples of 5+% break fees can be assembled by defendants in smaller, more typical US bids than those in this sample. US case law – reviewed briefly in Part III below – suggests it may suffice to defend a fee to show simply that it is not an outlier, and not satisfy the more difficult test that it is in line with overall averages. If so, then this variation will make it easier for defendants to prevail in US court challenges to fees, even if they have to incur costs to do so.

In sum, the data show that M&A break fees in practice vary significantly more in the UK than in the US, consistent with the litigation-driven US law in practice providing less clear guidance than UK regulation on the appropriate size of break fees relative to bid value. Given the clarity of the UK rule (the one percent cap), and the varied messages US courts have stated regarding the appropriate size of break fees, US deal-makers have considerably more flexibility in choosing the amount of deal protection than their UK counterparts.

Part III

III.A. Outcomes: Bid Competition, Bid Completion, and Bid Litigation

If break fees had no impact on bid outcomes, the differences between law and break fee size described above might be of practical importance to bid participants, but little overall significance. However, prior research has found that large break fees can have an impact on whether a given bid will attract competition, and on whether that bid will be completed. The difference in legal approaches to break fees – with the UK fees being kept below one percent and those in the US typically exceeding double that level or more – has a potential effect on allocational efficiency, as higher-valuing bidders in the UK are more likely to acquire a target than in the US, while bidders overall in the UK must take into account the risk that they will lose reliance interests (net of break fees) if they are outbid by competitors, whereas in the US that risk is substantially lower. The choice between regulation and litigation, in other words, may have an effect on bid incidence and the efficiency of the bid process. In addition, the *ex ante* and *ex post* approaches to governance can be expected to have another set of consequences: higher litigation costs for the latter. This section explores whether these effects can be observed in the large bid break fee data.

III.B. Univariate Results

As shown in Table 5 (Panel A), UK bids are more than twice as likely to encounter competing bids than bids for US targets. UK bids are less likely to be completed than US bids. This difference is attributable to the presence of competing bids, as the completion rate is statistically the same for both countries for bids with competition, or for bids without competition, with bids being completed less than 60% of the time in the presence of competition, and roughly 90% of the time without competition. For bids overall, it is the competition rate that is different, rather than the way that bidders compete conditional on competition.

Table 5. Outcomes for Large Bids in the US and UK, 1989-2008			
Panel A: All bids	UK bids	US bids	p-value
% with public bid competition	19.6 (n=209)	8.0 (n=1137)	0.00
% with litigation	0.0 (n=209)	5.0 (n=1137)	0.00
% completed	82.8 (n=209)	88.8 (n=1137)	0.01
without competition	88.6 (n=168)	91.7 (n=1046)	0.20
with competition	58.5 (n=41)	56.0 (n=91)	0.79
Panel B: Cash bids	UK cash bids	US cash bids	p-value
% with public bid competition	22.8 (n=209)	10.0 (n=1137)	0.00
% with litigation	0.0 (n=209)	3.9 (n=1137)	0.02
% completed	79.4 (n=209)	88.5 (n=1137)	0.00
without competition	84.7 (n=105)	91.8 (n=564)	0.02
with competition	61.3 (n=31)	58.7 (n=63)	0.81

One might wonder, based on the differences in bid consideration and bid duration presented above, whether it is those differences that are affecting competition rates. On reflection, however, those differences only make the contrast between bid completion rates in the US and the UK even more striking. The longer a bid takes to be completed, the longer third parties have to make a competing bid. Yet in the UK – where bids take less time because they are more commonly for cash – bids are completed less frequently than in the US, where they take more time, because they are more frequently for stock. In fact, as reflected in Table 5 (Panel B), the difference in completion rates spans choice of consideration: all-cash bids in the US remain more likely to be completed (89%) than all-cash bids in the UK (79%, p-value < .01). As with bids generally, cash bids are much less likely to be completed in the presence of competition – roughly 60% of the time, versus 90% without competition – and as before the differences in completion rates in the presence of competition are not statistically different. There is a statistically significant difference in completion rates of cash bids even without competition – 92% in the US vs. 85% in the UK, possibly reflecting greater power of institutional shareholders in the UK to refuse to tender to low-ball bids that may be attempted in the absence of competition – but the magnitude of that difference is much smaller than the difference in competition rates.

What about litigation? Does US reliance on court-enforced fiduciary duties to control the bidding process have an observable effect on the number of disputes generated by bids? The data in Table 6 suggest the answer to that question is yes: bids in the UK simply do not generate reported litigation,[17] whereas five percent do in the US. But that difference does not appear to be attributable to break fee disputes. Litigation is actually less frequent in US bids with break fees than in those without break fees (10% vs. 4%, p-value < .0001), and it is only in bids without reported break fees bid-related litigation reported in Thomson is statistically higher in the US than in the UK. Presumably this is because break fees deter bid competition, which is correlated with deal litigation in the

[17] Prior to the adoption of the bright-line rule in the Takeover Code, there was occasional litigation concerning break fees. See Tarbert 2003; Takeover Panel (UK), Decision 1986/2 (Jan. 29, 1986) (approving break fee adopted in fight between Guiness PLC and Argyll Group PLC for Distillers PLC).

US (8.7% of bids facing competition generate litigation reported in Thomson, versus 4.7% of bids without competition, p-value <.10).

Table 6. Litigation in Large Bids in the US and UK, 1989-2008			
Panel A: All bids	UK bids	US bids	p-value
% with litigation	0.0 (n=209)	5.0 (n=1137)	0.00
Break fee reported	0.0 (n=170)	3.7 (n=908)	0.22
No break fee reported	0.0 (n=39)	10.0 (n=229)	0.00
Panel B: Cash bids	UK cash bids	US cash bids	p-value
% with litigation	0.0 (n=136)	3.9 (n=627)	0.02
Break fee reported	0.0 (n=36)	2.8 (n=504)	0.31
No break fee reported	0.0 (n=100)	8.9 (n=123)	0.00

To further investigate the extent of US litigation specifically concerning break fees, a search of the Westlaw reported case decision database for fiduciary duty disputes involving break fees in the period 1989-2009. The search returned 224 reported case decisions that mention both mergers or tender offers and "break fee" or synonymous phrases.[18] A review of those decisions shows that a third – the [76] cases listed in Appendix A – were in cases concerned with the legitimacy of M&A break fees, either on their own or in combination with other claimed facts supporting a claim for breach of the target fiduciaries' duties.[19]

Grossed up to account for cases not generating reported decisions, a rough estimate of break fee litigation in the US in that period would be [114] cases.[20] One could characterize this number as large or small. Benchmarked against the UK, with zero litigation, it is significantly higher. Benchmarked against the ~[5000] bids for public targets in the US in the same time period, however, half the 5% litigation rate reported by Thomson for the large bid sample, and much smaller than the 34% of hostile bids reported by Thomson to encounter litigation in the US (Armour & Skeel 2007).

[18] A search of Westlaw's all cases database (including both Federal and state courts), using the search phrase "(merger or 'tender offer') and ('break fee' or "bust-up fee' or 'break-up fee' or 'termination fee') and 'fiduciary duty'" returns 224 cases, including a majority in Delaware courts (58%, roughly Delaware's market share of US public companies).

[19] The XX cases concerned with break fees are listed in Appendix A. The rest consist of cases in bankruptcy courts, which govern break fees differently than in normal bids; reverse termination fee cases, which involve fees payable by bidders rather than targets; disclosure cases; cases involving "termination fees" in unrelated contexts that happen to mention "merger" or "tender offer"; cases in which break fees are mentioned in passing, and cases not involving fiduciary duty claims.

[20] While reported decisions do not represent all cases filed, the multiple of complaints-to-reported-decisions is not as large as one might think: Thomas & Thompson 2004 report 348 fiduciary duty cases were filed in Delaware Chancery Court in 1999 and 2000; a search for "fiduciary duty" in the Westlaw Delaware cases database returns 224 reported decisions for the same time period.

Of the decisions listed in Appendix A, few articulate any "law" that would guide break fee practice. Many concern procedural issues (e.g., whether a complaint, that includes allegations that target fiduciaries breached their fiduciary duties by, among other things, agreeing to a break fee, states a claim; whether plaintiffs' attorneys who sued in part based on break fees are entitled to fees for their efforts). Of those that directly address the substantive question of when and what break fees are legitimate, several Delaware decisions explicitly refuse to provide clear general guidance on the proper size of a break fee, or specific facts that could justify or attack a larger-than-typical break fee, or approve a fee on the primary ground that the same size fee had been approved in prior cases.[21] Still, there are decisions[22] that explicitly allow custom and practice to guide case outcomes by dismissing complaints where the break fee in question was within norms, and it is hard to believe that courts would not be more inclined to approve a break fee within customary size ranges than one that is not.

In sum, the data are consistent with the general practitioner view that UK reliance on a regulatory approach to bid governance essentially eliminates bid-related litigation and its attendant costs, which is common in the US. At the same time, the more permissive stance towards break fees that has developed in the US litigation-based governance system may actually moderate the amount of bid-related litigation that occurs in the US, because break fees deter competition and competition generates disputes.

[21] E.g., Louisiana Municipal Police Employees' Retirement System v. Crawford, 918 A.2d 1172, Del.Ch. (Lamb, V.C.) (2007) (stating in dicta: "Though a "3% rule" for termination fees might be convenient for transaction planners, it is simply too blunt an instrument, too subject to abuse, for this Court to bless as a blanket rule."); In re Netsmart Technologies, Inc. Shareholders Litigation, 924 A.2d 171, 32 Del. J. Corp. L. 941, Del.Ch. (Strine, V.C.) (2007) (stating, in reviewing a deal that included a break fee the court characterized as "modest" in size, "The mere fact that a technique was used in different market circumstances by another board and approved by the court does not mean that it is reasonable in other circumstances that involve very different market dynamics."). Cf. Coates & Subramanian 2001 (recommending courts give bids with fees over 3% a "particularly hard look"), quoted in In re Toys-R-Us Shareholder Litigation, 877 A.2d 975, Del. Ch. (Strine, V.C.) (2005) (rejecting any bright-line rules; citing fact that a 3.75% fee was not "unprecedented" as part of basis for upholding fee).

[22] E.g., Gut v. MacDonough, Not Reported in N.E.2d, 23 Mass.L.Rptr. 110, 2007 WL 2410131, Mass.Super., August 14, 2007 (NO. CIV.A. 2007-1083-C) (break fees "are customarily included in agreements of this nature... the independent financial consulting firm hired by Westborough, RBC, concluded that ... the amount of the termination fee [i.e., 5%, was] reasonable...").

III.C. Multivariate Results

The basic univariate results presented above, showing higher break fees, higher competition rates, and lower completion rates in the UK, may be caused by other factors. Table 7 presents multivariate regressions that test this possibility to the extent feasible with available data. In each case, a simple model is reported, with a single explanatory variable (UK, =1 if the target is a UK firm); a second model is reported, with available controls other than year or industry fixed effects; and then a third model is reported, with both year and industry (one-digit SIC code) fixed effects. In parentheses are robust standard errors; coefficients or odds ratios that are statistically significant at the 95% level are in bold. In unreported regressions, the limited data on toeholds in Thomson's database was also included as a regressor, without affecting the reported results. Litigation is included in the models for completion rate, but omitted from the models for break fee size and competition rates, because of the likelihood of reverse causation.

Table 7.

Multivariate Regressions

	Break Fee Size (% of Bid Value)			Competition Rate			Completion Rate		
	Coefficients			Odds Ratios			Odds Ratios		
UK	**-1.728 (0.07)**	**-1.764 (0.089)**	**-1.902 (0.102)**	**2.805 (0.577)**	**2.547 (0.614)**	**2.717 (0.723)**	**0.604 (0.124)**	**0.232 (0.056)**	**0.191 (0.055)**
CASH		0.012 (0.064)	-0.128 (0.078)		**2.048 (0.438)**	**1.825 (0.456)**		**0.619 (0.115)**	**0.527 (0.120)**
TENDER		0.056 (0.079)	0.142 (0.079)		1.264 (0.299)	1.064 (0.279)		**5.712 (1.578)**	**9.023 (2.910)**
XBORDER		0.003 (0.079)	-0.022 (0.077)		0.740 (0.181)	0.760 (0.188)		1.557 (0.374)	**1.653 (0.423)**
BIDVALUE ($ billion)		**-0.009 (0.003)**	**-0.008 (0.002)**		**1.026 (0.009)**	**1.024 (0.008)**		0.992 (0.007)	0.989 (0.007)
LITIGATION								**-0.376 (0.148)**	0.877 (0.381)
Year FE	No	No	Yes	No	No	Yes	No	No	Yes
Industry FE	No	No	Yes	No	No	Yes	No	No	Yes
N	946	946	945	1346	1346	1296	1346	1346	1344
R-squared/ Pseudo-R-squared	0.009	0.132	0.213	0.026	0.055	0.092	0.005	0.063	0.126
	OLS			Logistic			Logistic		

As can be seen, after controlling for other observed factors, compared to the US, UK break fees are estimated to be even lower, competition rates to be even higher, and completion rates to be even lower than univariate tests would suggest. For break fees, the only significant control (other than time and industry dummies) is bid size: break fees increase at a decreasing rate in bid size. Other factors held constant, UK break fees are nearly two percentage points lower than US fees. For competition, cash bids encounter twice as much competition as other bids, other factors held constant; and for each ten billion dollars a bid is larger, the competition rate increases by a multiple of 10.3. Industry and time controls only sharpen the effects on bid competition, which is nearly three times as likely in the UK than in the US. UK bids, which appear to be completed about 60% as often as US bids in a univariate regression, become even less likely to be completed after taking into account the combined effects of the higher incidence of cash consideration (which reduces the odds of bid completion), the higher incidence of tender offers (which dramatically increases the odds of bid completion), and cross-border bids (which are more likely to close). Litigation, present only in the US, appears to reduce the odds of deal completion, but this effect does not persist after inclusion of time and industry controls.

If we replace the UK dummy with break fee size in the models of bid competition or bid completion, or we get similar results. In unreported results, break fee size is statistically significant correlated (p<.01) with bid competition and bid completion, with and without the same controls show in Table 7. The point estimates are reasonable and economically significant. In models with year and industry fixed effects, for every point higher a break fee is as a percentage of bid value, the odds of a competitive bid are reduced by 28% -- e.g., from a sample average of 10% to 7.2%. Likewise, the odds of bid completion are increased by 128% -- e.g., moving from a typical UK break fee of 1% to a typical US break fee of 3% would increase the completion rate from 90% to about 93%.

IV. Limits and Lessons

IV.A Limits. A number of factors may limit the extendability of the analysis in this paper. First, M&A bid contests typically promise large benefits to well-funded market participants. The parties affected by break fee governance can, in some general sense, afford both to lobby and litigate, and are, in very general terms, evenly matched. This is not a context in which, for example, of disputes between large, organized, well-funded producers and dispersed resource constrained individuals. One exception – discussed briefly above – was the absence of organized institutional shareholders in the US when hostile bids first emerged in the 1950s, but even that absence has dissipated over time. Second, M&A contests have few large externalities that are identifiable ex ante (other than on bidders and shareholders). While the choice of bidder may in fact have important third-party effects (through layoffs, increases in creditor risk, changes in taxes), these effects and their precise incidence are rarely known in advance. Third, M&A break fees are not generally salient – in either political or moral terms – to the public. No politician directly elected by the general population is ever likely to get elected because of his/er position on break fees.

IV.B. Lessons. With those limits in mind, what are potential lessons from the contrast between the UK and US approaches to M&A break fees?

IV.B.1 Observed Advantages of Regulation

The UK's regulatory approach exhibits clear benefits. It generates little or no litigation, provides clear guidance for market participants, keeps fees low, and increases bid competition. More generally, it may make it harder for target fiduciaries to favor bidders for private benefits, but such a conjecture presumes target fiduciaries are not otherwise constrained or incentivized properly, and that ex post litigation would do a worse of job of constraining target agency costs than regulation.

IV.B.2 Observed Advantages of Litigation.

On the other hand, by capping fees at what is a low amount, relative to that chosen in the less regulated US M&A environment, UK regulation likely results in the underprovision of insurance for bidders for transaction and opportunity costs if they bid and another bidder ultimately prevails, and for the non-contractible certification benefit a bid gives a target. Given that 95% of US break fees exceed the one percent cap applicable in the UK, it seems unlikely that all of these fees represent target agency costs. The US's litigation approach likely permits more value-adding fees to be used.

The result is likely to be more bidding in the US than in the UK. If targets are otherwise forced or pressured to sell themselves, the social loss may not be significant. But if targets can and do refuse to put themselves "in play" with a bid they consider too low, and if bidders hold back because they cannot insure against competition risk, there may be welfare losses from too little M&A in the UK. Rossi & Volopin 2004 report that 66% of US listed firms were acquired in their cross-country analysis of Thomson's M&A database, versus only 54% of UK listed firms in the same period. To be sure, factors (legal or non-legal) other than break fees may explain this difference: the US economy may be more dynamic and less dependent on cross-border M&A to achieve economies of scale or scope or other benefits of deal activity, and other rules (e.g., the mandatory bid rule, rules governing takeover defenses) and practices (e.g., compensation, executive severance) may drive the difference. Even if it could be established that the UK has less M&A than the US as a result of break fee governance, some would argue that is a good thing, as many deals may be driven by misvaluations or other market imperfections (e.g., Shleifer & Vishny 2003). Net benefits of UK regulation of fees are difficult to gauge, at best.

IV.B.3 Missing Advantage of Regulation.

While the UK approach seems to provide some of the conventionally identified benefits of regulation, it does not seem to reflect one: expertise. While the UK Takeover Panel does have greater expertise than generalist courts, it does not seem to have used that expertise in devising its rule on break fees. Nothing in the brief statement accompanying the adoption of the one percent rule suggests that any careful study or analysis went into the rule, and the Panel has left it unchanged for the past 10 years. Indeed, given the character of the rule, it is hard to see how the Takeover Panel could develop expertise; with variation essentially eliminated, they have lost the ability to look for differential effects of different fees.

IV.B.4 Missing Advantage of Litigation

Likewise, the US approach, while preserving greater flexibility and variation in break fee use, does not seem to reflect one of the conventionally identified benefits of litigation: evolution towards clearer and better standards over time. US courts, particularly in Delaware, seem to go out of their way to refuse to provide guidance on what is or is not an acceptable fee, retaining discretion to find the same fee acceptable in one case and unacceptable in another, based on factors that they never identify clearly. The general standard used in Delaware – fees that induce bids are more likely to be acceptable, fees that preclude bids are more likely to not be acceptable – is useless as a guide to practice, since most fees do both. This standard is the same standard used 20 years ago, after dozens of cases have presented Delaware's chancery with the opportunity to refine or clarify the standard. As a result, litigation over break fees in the US continues at a high pace, showing no signs of diminishing over time.

IV.B.5 Stasis in Both Regimes

Neither the UK nor the US seem to exhibit meaningful legal change over time, as applied to break fees. Legal inertia can be a benefit: it allows for greater awareness of the legal rule to spread and shape behavior, and it encourages private parties to make investments that depend on the law not changing. On the other hand, if laws are imperfect but can be improved over time, with experience, the fact of inertia in both regimes may be troubling. It is consistent with a public choice explanation of law in both nations.

IV.B.6 Interaction of Lawmaker Incentives and Private Interests

In the UK, the Takeover Code is still dominated by institutional shareholders, who reap the immediate benefits of greater competition conditional on a bid, and whose power to choose among bids would be diminished by a looser regime governing break fees. A looser regime might benefit shareholders by encouraging more bidding, but the incidence of increased M&A would be hard to predict, and would be shared with bidders and other market participants, who face collective action problems already overcome in the UK by institutions represented on the Takeover Panel. By reflecting institutional shareholder dominance in the membership rules governing the Takeover Panel, the UK has institutionalized a political victory dating back to the 1950s, which seems highly unlikely to be open to legal changes that would hurt its dominant constituency, even if doing so would benefit the economy or society. In addition, the structure and incentives of the Takeover Panel may explain the initial choice of a bright-line rule. Although the Panel has a full-time staff, Panel members themselves (who decide Panel policy and resolve disputes) have other full-time jobs, and are not compensated for their work on the Panel, which at least blunts – and probably reverses – any incentive they might have to maintain vague standards to preserve disputes. When break fees began to be used more widely in the 1990s in the UK, the rule adopted by the Panel minimizes the need for Panel guidance or dispute resolution on break fees, reducing the time demanded of Panel members.

In the US, break fee law remains an opaque preserve of professional lawyers and courts. The loose standards used to evaluate fees generate widely varying business norms and expensive litigation, and prevents others from easily knowing what is and what is not legal, in a key aspect of M&A practice. This state of affairs generates rents for litigators and transactional lawyers, who can honestly claim an ever-so-slightly greater ability to read the legal tea-leaves in a particular context, and leverage that advisory role into boardroom networks and repeat business. It also makes life more interesting for judges, who serve full-time multi-year terms, until they retire and join the ranks of well-compensated lawyers. Vice Chancellor Lamb, who wrote one of the recent Delaware decisions firmly rejecting bright-line rule-like approaches to fee review,[23] recently announced that he would be joining a major US law firm as managing partner of a new Delaware office.[24] One need not imagine – and I do not suggest – that the Vice Chancellor had any intent to benefit his future self in writing that decision. All that was required was a judiciary socialized in a culture of standards-based justice. The Chancellors and other Vice Chancellors have exhibited similar concerns for "justice" as expressed in a resistance to rules in favor of standards.[25] In the US, the cadre of deal lawyers are at the forefront of defending Delaware, and its judiciary, against the slightest risk of intrusion by Congress or the SEC and its tendency towards bright-line rules.[26]

At the same time, a simple dichotomy of UK regulation protected by institutions and US litigation protected by lawyers is overly simple. The UK approach to break fees is in the context of a legal system that still relies to a significant extent on litigation. Even the subject of M&A is governed by a system that is at most a hybrid – a specialized regulatory body applying general standards – but using a bright-line rule for break fees. And the US approach is in the context of a legal system that is replete with bright-line rules, including rules adopted by the SEC,[27] statutes adopted by the Delaware legislature,[28] and rules articulated by the Delaware courts.[29] In the US, too, institutional shareholders have become increasingly active in politics over the past twenty years, but have exhibited no general preference for regulation over litigation, and no interest in lobbying to law relevant to break fees. At a minimum, this suggests that a plausible theory of the incidence of regulation and litigation will require finer explanatory variables than those that apply to nations as a whole, such as their legal origin, and will need to include some allowance for historical contingencies. A theory that points to differential collective action costs will need to attend to the fact that the same set of trade

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[23] Louisiana, supra note __.

[24] See www.paulweiss.com/resources/news/detail.aspx?news=1947 (law firm announcement).

[25] Netsmart, supra note __ (Strine); Orman v. Cullman, 794 A.2d 5, 45 (2002) (declining to adopt bright-line test for whether a consulting fee was material for purposes of determining a director's independence in reviewing a conflict transaction) (Chandler, C.).

[26] Comments from major law firms on the recently proposed SEC rule providing shareholders access to company proxy statements illustrates the point. See www.sec.gov/comments/s7-10-09/s71009.shtml, and particularly the comment from seven law firms, available at www.sec.gov/comments/s7-10-09/s71009-212.pdf at 3 (suggesting the SEC not adopt its proposed rule 14a-11 "in the interests of federalism" in order to allow state law initiatives in Delaware and elsewhere "to flourish").

[27] E.g., companies with more than $10 million in assets and 500 shareholders must register with the SEC. Securities Exchange Act of 1934 § 12(g)(1); SEC Rule 12g-1.

[28] A majority of directors and a majority of shareholders may approve a merger of a company with another and, if desired, cash out other shareholders, by following formal steps specified in D.G.C.L. § 251.

[29] For example, Delaware shareholders may not seek to enjoin a merger simply on the ground that it will convert their stock into cash or stock of another company (Weiss 1983).

organizations and institutions can produce a system that includes bright-line rules and vague standards simultaneously. The vices and virtues of each method are likely to have different values at different levels of legal specificity. Exploring law with that much precision will no doubt complicate the theory, and perhaps make it difficult to articulate any plausible regularities spanning laws within a nation, much less across multiple nations, and make it harder for an institution like the World Bank to use the analysis to create simple rule-like schemes to reward or punish growth-oriented legal reform. More complex theories, however, may have the merit not only of simplicity but also of truth.

Conclusion

This paper has contrasted UK and US governance of M&A break fees with a view to what the contrast can teach us about the trade-offs between litigation and regulation, including how laws change under each regime over time. The UK caps fees at a low level with a simple *ex ante* rule based not on regulatory expertise but on an arbitrarily chosen percentage of bid value, which nonetheless has the virtues of clarity and lower litigation costs, and enhances competition conditional on an initial bid. US courts evaluate fees *ex post* with a complex standard, allowing for greater variation and higher average fees, reducing the risk of bidding and possibly increasing M&A overall, at the cost of significant amounts of ongoing litigation, in part because courts resist articulating clear rules. Laws in each nation exhibit inertia; are protected by entrenched interest groups (institutions in the UK, lawyers in the US); and co-exist with the opposite approach (litigation in the UK, regulation in the US), even within the domain of M&A law. Subject to strong limits on external validity, the case study suggests that interest groups may be the most important factors shaping the initial choice between regulation and litigation, even for otherwise similar nations in a similar context, and that a combination of interest groups formed in response to a given choice, as well as lawmaker incentives, may preserve those choices even after the conditions giving rise to the initial choice have passed away.

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