EVALUATION OF BREAK FEE CLAUSES IN M&A CONTRACTS WITHIN THE FRAMEWORK OF UK LAW IN TERMS OF UNLAWFUL FINANCIAL ASSISTANCE*

Birleşme ve Devralma Sözleşmelerinde Yer Alan "Break Fee" Klozlarının Birleşik Krallık Hukuku Çerçevesinde Finansal Yardım Yasağı Yönünden Değerlendirilmesi

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ABSTRACT

The ban on financial assistance aims to prevent the usage of company resources for external interests and protect the shareholders and creditors of the company. The justification for this restriction is that a company's resources should be exclusively for the benefit of that company itself, not to facilitate the acquisition of its shares.

A break fee clause (or agreement) is a deal protection mechanism which requires a target company to pay a bidder a certain amount of fee if the target doesn't complete the proposed transaction. Break fees serve another purposes in addition to protecting the deal. In terms of the bidder, it enables the bidder to recover its costs arising from due diligence, legal fees, or applications to obtain regulatory approvals required for the transaction. On the other hand, from the target company's point of view, a break fee clause can be viewed as an opportunity for the target to refuse the completion of the deal at a known cost.

Break fee agreements could be characterized as "other financial assistance" under UK case law because they "*smooth the path towards the acquisition of the shares".* In this context, if a break fee agreement as "other financial assistance" reduces the net assets of the company to a material extent or the target company has no net assets, unlawful financial assistance occurs under the Companies Act 2006.

Keywords: Break Fee Agreements, Unlawful Financial Assistance, Deal Protection Mechanism

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ÖZET

Finansal yardım yasağının amacı, şirket kaynaklarının şirket dışı çıkarlar için kullanılmasını önlemek ve böylelikle hissedarları ve alacaklıları korumaktır. Bu yasak ile şirket kaynaklarının, şirket hisselerinin satın alımı için kullanılması engellenmek istenmiştir.

Break fee anlaşmaları, hedef şirketin, satın alma işlemi tamamlanmadığı takdirde alıcıya belirli bir ücret ödemesini gerektiren bir anlaşma koruma mekanizmasıdır. Bu anlaşmalar anlaşmayı koruma amacının yanı sıra başka amaçlara da hizmet etmektedir. Bu anlaşmalar alıcının; due diligence giderleri, avukatlık ücretleri veya gerekli regulasyonel onaylar için yapılan masrafları geri alabilmesini sağlamaktadır. Hedef şirket açısından ise; satım anlaşmasının tamamlanmasını bilinen bir maliyetle reddetme fırsatı olarak görülebilmektedir.

Öte yandan, break fee anlaşmaları "hisselerin satın alma yolunu kolaylaştırdığı" gerekçesiyle Birleşik Krallık Hukuku kapsamında finansal yardım türlerinden olan "diğer mali yardım" olarak nitelendirilmektedir. Bu bağlamda, "diğer mali yardım" niteliğindeki break fee anlaşmaları, şirketin net varlıklarını önemli ölçüde azaltmakta ise yahut hedef şirketinin net varlığı bulunmuyorsa, 2006 tarihli Birleşik Krallık Şirketler Kanunu gereğince hukuka aykırı şekilde bir finansal yardım gerçekleşmiş olacaktır.

Anahtar Kelimeler: Break Fee Anlaşmaları, Finansal Yardım Yasağı, Anlaşma Koruma Mekanizması

INTRODUCTION

The term "financial assistance" refers to a company providing financial assistance to a potential buyer for the purchase of its own shares and the shares of its parent company.[1] Financial assistance could be made by way of a gift, guarantee, security, or any other agreement[2] to be used to buy the target company's shares. Financial assistance is banned in many jurisdictions, such as the UK, Türkiye and Singapore, aiming to protect creditors and shareholders.[3]

Break fee clauses are provisions included in merger and acquisition (M&A) transactions that require the target company to pay the bidder a certain amount of fee if the target doesn't complete the deal.[4] These clauses are also called "target termination fee" or "break-up fee". Regardless of their name, their function is to protect the deal.

1 Alan Dignam and John Lowry, Company Law (11th edn, OUP Oxford 2020) 132; Maisie Ooi, 'The Financial Assistance Prohibition: Changing Legislative and Judicial Landscape' (2009) 2009 Sing J Legal Stud 135, 135.

2 For more type of financial assistance see s. 677 of the Company Act 2006.

3 Section 380 of Turkish Commercial Code and Section 76 of Companies Act 1967 of Singapore.

4 Micah S. Officer, 'Termination fees in mergers and acquisitions' (2003) 69 Journal of Financial Economics 431, 432.

This article addresses the fact that break fee clauses are commonly used in M&A transactions in many jurisdictions and aim to compensate the bidders' damages arising from the termination of the transaction. Since break fee clauses are prevalent contractual provisions in M&A transactions, various types of disputes may arise while enforcing them, such as the validity problem of these clauses. One of the major controversial issues regarding break fee clauses is whether they constitute unlawful financial assistance which is prohibited in many national laws and specifically in the UK Company Law we will address below. The main research question of this study is whether or not the inclusion of break fee clauses in M&A contracts breaches the prohibition of financial assistance, and if it does, under what conditions it does so.

This study proceeds as follows:

Section 2 examines the definition and purpose of the concept "unlawful financial assistance" and the rationale behind it. Section 3 deals with the comparison between unlawful financial assistance and capital maintenance doctrine. Section 4 examines types of unlawful financial assistance under the Companies Act 2006. Section 5 addresses the main research question of this study, which is whether break fee clauses constitute unlawful financial assistance under the Companies Act 2006. And finally, Section 6 concisely summarizes the conclusions reached.

A. The Concept of "Unlawful Financial Assistance"

The discussions on the prohibition of financial assistance in the UK date back to 1929. This prohibition was initially adopted through the enactment of the Companies Act 1929.[5] The prohibition of financial assistance is finally set out in the Companies Act 2006 between sections 677 and 683.

Section 678 of the Companies Act determines the essential elements of "unlawful financial assistance". Pursuant to this provision, it is unlawful financial assistance for a company to give financial assistance directly or indirectly to a natural person or legal entity seeking to acquire that company's shares or its parent company's shares before or at the same time as the acquisition takes place.

The prohibition of financial assistance by law aims to prevent the usage of company resources for interests not belonging to the company and to protect the shareholders and creditors of the company. The rationale behind this prohibition is that a company's resources should only be used for the benefit of the company, not to facilitate the acquisition of its shares.[6]

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5 See Chan Wai Meng & Sujata Balan, 'The Civil Consequences for Breach of the Prohibition against the Giving of Financial Assistance: The Malaysian Approach' (2008) 10 Austl J Asian L 77, 79ff.

6 ibid 80.

This prohibition protects the creditors of a company by preventing the depletion of its sources. Shareholders are also protected by this prohibition against purchases they are not involved in or they do not accept by not letting the management or controlling shareholders utilize the sources of the company.[7] *Dignam and Lowry* exemplify the reasons for this prohibition in the context of exchange markets, saying that a listed company could give money to people to acquire its shares and thus affect its share price depending on increased demand, thereby creating an incorrect apperance of the true value of its shares. This exemplifies the abusive financial assistance provided by the company management to potential investors.[8]

Under the Companies Act 2006, the scope of the prohibition is limited to public companies and their subsidiaries (whether public or private), and this prohibition applies to financial assistance provided before or after the acquisition. The prohibition was removed in terms of private companies, except for those which are subsidiaries of a public company.[9]

B. The Relationship between Unlawful Financial Assistance and the Doctrine of Capital Maintenance

Prohibition of financial assistance is regarded as one of the consequences and concrete reflections of the doctrine of maintenance of capital.[10] The doctrine of maintenance of capital is based on the opinion that the capital of companies should be maintained but should not be reduced or distributed, since the capital constitutes security for the company's creditors.[11] In this respect, some rules that are considered to be underpinned by the capital maintenance doctrine have been provided in national laws, such as the purchase of its own shares by the company, unlawful financial assistance, and restriction of dividend payments meaning that they must only be made from distributable profits.[12]

However, while provisions regarding the prohibition of unlawful financial assistance are considered to be based on the doctrine of capital maintenance, it is also argued that the rationale behind the prohibition of financial assistance was not only the need to maintain capital but also the prevention of potential risks the company, the shareholders, and creditors may face, as well as abusive practices by acquirers and the management of the company. In other words,

7 Philip Marshall, 'Unlawful financial assistance: rising from the dead' (2017) October Butterworths Journal of International Banking and Financial Law 531, 531-532.

8 Dignam and Lowry (n 1) 132.

9 Marshall (n 7) 531.

10 Ann Ridley, *Key Facts Company Law* (4th edn, Taylor & Francis Group, 2011) 72.

11 ibid 70.

12 Md. Saidul Islam, 'The Doctrine of Capital Maintenance and its Statutory Developments: An Analysis' (2013) 4 The Northern University Journal of Law 47, 48.

the aim of this prohibition is wider than the maintenance of capital, protecting the shareholders and creditors from abusive behaviors of the company management, which uses its own assets to finance the purchase of its own shares. Therefore, even in some cases where the capital maintenance doctrine is not violated and the capital or assets of the company are not reduced, such as by giving loans[13], unlawful financial assistance may still take place.[14]

C. Types of Unlawful Financial Assistance Under the Companies Act 2006

Section 677 lays down the situations that constitute unlawful financial assistance in a way that is not "numerus clauses". Examples of unlawful financial assistance laid down in this section include assistance given by way of a gift, guarantee, security, or indemnity (other than an indemnity in respect of the indemnifier's own neglect or default), by way of release or waiver**,** by way of a loan or other agreement, by way of the novation of, or the assignment (in Scotland, assignation) of rights arising under, a loan or such other agreement, or any other financial assistance.[15] In this regard, unlawful financial assistance may occur if a company lends or gives money to someone to buy its shares or to pay back a bank loan taken out to buy its shares; releases a debtor from liability to the company to assist the debtor to buy its shares; guarantees or provides security for a bank loan for the purchase of its shares; or provides financial assistance by buying the acquirer's assets at an overvalued price to help the acquirer buy its shares.[16]

The Companies Act 2006 also sets out the situations where a company gives any kind of financial assistance to a potential acquirer and thereby reduces its net assets to a material extent, and any other financial assistance where the company has no net assets [Section 677 1(d)]. The title "any other financial assistance" is important in terms of the question of "whether break fee clauses constitute unlawful financial assistance", which is addressed below.

D. Does a Break Fee Clause Constitute Financial Assistance?

The issue of whether break fee clauses in M&A transactions breach the prohibition of financial assistance is controversial in UK Law. Discussions on this subject have arisen from a court decision made in 2012. However, there is no clarity or explicit provision for it. It seems like the courts may face and decide on another claim in this context in the future and may determine the criteria.

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13 In such cases, although funds leave the company, their loss is mirrored in the company's records by the debt that is therefore created, so they do not reduce the company's net assets. See Dignam and Lowry (n 1) 134.

14 Dignam and Lowry (n 1) 134.

15 ibid 135.

16 Ridley (n 10) 76.

In this respect, initially, it is necessary for reaching a conclusion to make an assessment of the legal nature of break fee clauses and the transactions and acts that cause unlawful financial assistance under the Companies Act 2006 and then determine whether break fee clauses fit into the unlawful financial assistance methods laid down in Section 677 and subsequently, the legal outcomes of the breach (if any) should be addressed.

1. The Concept of "Break Fee Clause"

Break fee clauses, which are also called "target termination fee" or "break-up fee," are provisions included in merger and acquisitions (M&A) transactions as a deal protection mechanism that require that the target company pays the bidder a certain amount of fee if the target does not complete the proposed transaction.[17] Break fees are essentially fixed payments paid by one party to another according to specified conditions.[18]

Break fee clauses include the payment amount, which is determined as either a percentage of the transaction's value or a specific amount of money, and a list of conditions that are the grounds of the payment.[19] The conditions that are the grounds for the payment of the break fee usually include, but are not limited to, the target company's breach of any warranties or covenants, for instance, not obtaining necessary regulatory approvals, rejection of the transaction by the board of shareholders, or acceptance of a third-party bid.[20]

Break fee clauses aim not only to protect the deal between the parties but also serve other purposes. In terms of the bidder, it enables the bidder to recover its costs and expenses arising from due diligence, legal fees, or applications to obtain regulatory approvals to make the transaction.[21] On the other hand, from the target company's point of view, a break fee clause might be regarded as an opportunity enabling the target company to reject completion of the deal at a known cost.[22]

2. Assessment of the Legal Nature of Break Fee Clauses Under Section 677 of the Companies Act 2006

When evaluating whether break fees constitute unlawful financial assistance, the acts and transactions that are laid down as unlawful financial assistance in

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17 Officer (n 4) 432.

18 Heath Price Tarbert, 'Merger Breakup Fees: A Critical Challenge to Anglo-American Corporate Law' (2003) 34 Law & Pol'y Int'l Bus 627, 638.

19 Tarbert (n 16) 639.

20 Tarbert (n 16) 639; Paul Andre, Samer Khalil and Michel Magnan, 'Termination Fees in Mergers and Acquisitions: Protecting Investors or Managers?' (2007) 34 3-4 Journal of Business Finance & Accounting 541, 542.

21 ibid 632, 641; Frank C. Butler and Peter Sauska, 'Mergers and Acquisitions: Termination Fees and Acquisition Deal Completion' (2014) 26 1 Journal of Managerial Issues 44, 45.

22 Tarbert (n 16) 641.

Section 677 of the Companies Act 2006 and whether break fee clauses fit into them should be reviewed. In this respect, it is very important to benefit from case law and its interpretation, which have dealt with break fees in terms of the prohibition of financial assistance, because there is vagueness on this subject.

In our opinion, since there is no ambiguity or disagreement about whether break fees are not "gifts" or "loans", in this subsection we try to answer the questions of whether break fees qualify as "indemnity" and also whether break fees are only "inducements" for the bidders or whether they can be considered under the umbrella of "other financial assistance" laid down in Section 677.

a. Assessment of the Legal Nature of Break Fee Clauses and Indemnities

Indemnification or providing indemnity can be defined as a method by which a legally responsible party (indemnitee) shifts a loss to another party (indemnifier).[23] In addition to their contractual version, indemnities can also be imposed by law, which is not addressed here.

Indemnities aim to provide one party to a contract, for instance, a buyer, with a contractual remedy for recovering post-closing damages arising from breach of the contract or any other reasons set out in the indemnification agreement between indemnitee and indemnifier. In other words, indemnities provide one party to the contract with protection against losses incurred, even against third party claims, depending on the scope of the indemnification agreement.[24]

Indemnification agreements' scope of protection may vary in terms of amount. In some cases, there is a maximum amount of damage, which is called "cap" indemnitee has right to recover from the indemnifier. On the other hand, in some other cases there might be some minimum limits or thresholds called as "basket" which means the amount of loss the indemnitee incurs must exceed the threshold so that the indemnitee is entitled to recovery.[25]

Within the framework of this explanation regarding indemnities, it can be easily said that break fee agreements are similar to indemnities. However, in our view, even though they both aim to serve the purpose of protection against losses and they both originate from agreements, they differ in some aspects.

Initially, break fees are a sum of compensation that is agreed upon by the parties. In the event of the dissolution of an M&A deal, the target pays the break fee regardless of the actual or potential loss to the bidder. Even if the bidder's loss exceeds the break fee, the target is not under obligation to

23 D. Hull Youngblood, Jr. and Peter N. Flocos, 'Drafting And Enforcing Complex Indemnification Provisions' (2010) August The Practical Lawyer 21,22.

24 ibid 22.

25 ibid 30-31.

compensate this exceeding amount.[26] Briefly stated, no matter how much the loss to the bidder is, the amount of the break fee that will be paid to the bidder can't go beyond the amount determined in the break fee agreement in advance of the termination of the M&A deal. However, indemnities must necessarily keep the indemnitees "harmless against loss", which means fully reimbursing the losses of the indemnitees.[27] Undoubtedly, in practice, indemnities are limited to certain amounts of reimbursement called "cap" and "basket". In other words, indemnities are legal instruments fully reimbursing the "covered loss" of indemnitees. Accordingly, indemnifiers are under obligation to fully reimburse the covered loss and the compensation varies depending on the loss the indemnitee incurs. To summarize, break fees and indemnities differ in terms of the full recoverability of the losses the indemnitee incurs, and therefore, in our view, it is not technically possible to define break fee clauses as indemnity which also constitute unlawful financial assistance in this sense.

On the other hand, even if break fees qualify as indemnity, they still do not constitute financial assistance because of the exception in Section 677/1-b(i).[28] Section 677 establishes that an assistance given by way of indemnity in respect of the indemnifier's own neglect or default does not constitute unlawful financial assistance. In this respect, even if it is open to discussion to bring forward the argument that break fees constitute unlawful financial assistance because they have same qualifications as indemnities, Section 677 clearly provides that indemnities given in respect of the indemnifier's own neglect or default (which means, in the case of a break fee agreement, giving the bidder an indemnity by the target against losses incurred by the bidder because of the termination of the M&A deal by not completing the transactions by the target) do not constitute unlawful financial assistance**.** Therefore, in our view, even if break fee clauses are technically regarded as indemnity, these clauses do not constitute unlawful assistance in the presence of Section 677/1-b(i).

Finally, in *Paros Plc v. Worldlink Group Plc* case, the Court made a legal assessment regarding whether break fees constitute unlawful financial assistance. The Court stated that the break fee clause in the transaction is an indemnity in respect of liabilities, and the related clause, which is expressed to be a "break fee", is also financial assistance**.** The Court expressed that *"On a proper construction, ..., it is also an indemnity in that it is payable only in respect of fees and costs actually incurred"* and added *"Even if that construction is incorrect ... the break fee is 'other financial assistance' and has a material effect on the net assets of Worldlink".*[29] As can be seen that the Court

[26] Tarbert (n 16) 689.
[27] ibid 689.
[28] ibid 688.
[29] *Paros Plc v. Worldlink Group Plc* [2012] EWHC 394 (Comm) [68]-[69].

addressed the possibility of whether break fees are regarded as an indemnity and therefore constitute unlawful financial assistance, but ultimately based its decision on unlawful financial assistance on "other financial assistance" set out in Section 677 which is explained below.

b. "Other Financial Assistance" Smoothing the Path to the Acquisition of Shares

Assuming that break fees may not qualify as indemnity and therefore unlawful financial assistance, it is necessary to make an assessment about them in terms of whether they constitute "other financial assistance" and review their impacts on the company's net assets.

Under Section 677/1(d), unlawful financial assistance takes place if any "other financial assistance" given by a company;

a) reduces the net assets of the company to a material extent, or

b) the company has no net assets.

The provision of Section 677/2 defines the term "net assets" as the aggregate amount of the company's assets less the aggregate amount of its liabilities. However, the Act doesn't say anything about "materiality". In this respect, courts will make their own assessments of "materiality" case by case because the criterion "materiality" depends on the size and economic power of the related company. It is possible that an amount of assets may be material for some financially smaller or struggling companies, whereas the same amount of assets is immaterial for a financially strong company.[30] In *Chaston v SWP* case[31] the company had limited net assets, and the payments constituting "other financial assistance" amounted to 20 percent of its net assets and therefore found material by the Court. In our view, no matter how big and financially strong the company is, a reduction of net assets by 20 percent by means of break fees or any other financial assistance is obviously material and should be found unlawful.

On the other hand, it is justifiably argued that a percentage-based test for "materiality" of the reduction in net assets of the company in terms of the establishment of unlawful financial assistance may not be appropriate for certain industries. Even though the percentage of reduction in net assets of the company is below the threshold set by courts, where the related company is a long-standing entity and the sector is a capital-intensive, non-growth, low profit-margin sector, even the smallest percentage of reduction in net assets can be material for the company when compared to its annual revenue of the

30 Eilís Ferran, 'Corporate Transactions And Financial Assistance: Shifting Policy Perceptions But Static Law' (2004) 63(1) Cambridge Law Journal 225, 232.

31 *Chaston v. SWP Group plc* [2002] EWCA Civ 1999.

company.[32] Therefore, courts should review and evaluate each transaction one by one rather than using a standard approach.

To recap, as we mentioned above, to be able to identify an action, or transaction, or any other thing as unlawful financial assistance in the context of Section 677/1(d), two different conditions should be met. First, the action or transaction shall qualify as financial assistance and be included in the term "other financial assistance". Second, the net assets of the company shall be reduced to a material extent by the assistance, or the company shall have no net assets. As we already addressed the conditions regarding the impacts of financial assistance on the net assets of the company required for the establishment of unlawful financial assistance in the Section 677/1(d), now it needs to be dealt with the questions of "what actions and transactions constitute other financial assistance?" and particularly "do break fees constitute "other financial assistance" under Section 677/1(d) in the light of case law?"

In *Chaston v. SWP Group plc* case, the target company's subsidiary paid a portion of the bidder's due diligence costs, which include accountancy and advisory fees of nearly £20,000. The Court ruled that section 151 of the Companies Act 1985 (now corresponding to section 677) was violated because, as a matter of commercial reality, the fees paid by the target company's subsidiary smoothed the path to the acquisition of shares.[33] This decision is of importance because, although whether break fees violate Section 677 or whether break fees can be regarded as "other financial assistance" in terms of legal characteristics is not discussed here, the court made a decision that may quide other courts in similar cases. The Court determined a criterion regarding "other financial assistance" in this decision. According to the Court, to be able to identify an action or transaction or anything else as "other financial assistance", it needs to be established that the action or transaction smoothes the path to the acquisition of shares.

In *Paros Plc v. Worldlink Group Plc* case, the Court ruled that the break fee is "other financial assistance" and has a material effect on the net assets of Worldlink. According to the Court, "*it is financial assistance because it is a proposed financial payment which smooths the path towards the acquisition of the shares."* and the court justifies this opinion as follows: "*if Worldlink withdrew from the negotiations .., ParOS was certain to recover a minimum contribution towards its expenses. As such the fee was 'smoothing the path to the acquisition of the shares' because it enabled ParOS to incur up to £150,000 of expenditure in progressing the proposed acquisition secure (or virtually so)*

[32] Tarbert (n 16) 690.
[33] Ferran (n 32) 230.

that it would be reimbursed to that extent if the transaction failed."[34]

Also, the Court stated in response to considerations in *Barclays Bank plc v. British & Commonwealth Holdings plc* Award regarding whether break fees are only an inducement that "*the break fee was not a mere inducement to enter into the transaction (if relevant). I consider that it amounted to 'other financial assistance' and that it materially reduced the net assets of Worldlink, given that they were negative at the time*."[35] The Court addressed the materiality issue as well, stating that "*there is no authority on the meaning of material… . … Where, as here, the company has negative net assets, the reduction is plainly material."*[36]

Finally, it should be emphasized that it is clear that Section 677 applies to cases where a person (natural or legal) acquires or only proposes to acquire shares in the target company. Even if the transaction is not complete and fails, unlawful financial assistance remains because it is sufficient in the context of Section 677 only to propose the acquisition.[37] In this context, it is stated by Professor Ferran that "*principle that a company's money should not be spent in helping someone to buy shares has never spelt out in such precise terms as to exclude cases where no acquisition actually takes place*."[38]

3. Legal Sanctions Against Break Fee Clauses Qualifying As Unlawful Financial Assistance

Section 680 provides that breach of the prohibition of financial assistance is a criminal offense requiring a fine for the company and its officers. This is the consequence of the breach in terms of criminal law. The other consequences of this breach relate to civil law. Breach of this prohibition can make the transaction (break fees in our case) unlawful and also negatively affect the enforceability and validity of the underlying agreement.[39]

As regards the consequences of the breach, it can be said that the agreement on financial assistance can't be enforced since the agreement is unlawful. In this regard, we can say that the bidder can't enforce the break fee clause if it constitutes unlawful financial assistance.[40]

As to the M&A transaction, it can be stated that if the break fee agreement, which constitutes unlawful financial assistance, is included in the M&A agreement, the M&A agreement can only be enforceable if it can be severed

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34 *Paros Plc v. Worldlink Group Plc* (n 31) [69] – [72].
35 *Paros Plc v. Worldlink Group Plc* (n 31) [72].
36 *Paros Plc v. Worldlink Group Plc* (n 31) [70].
37 Ferran (n 32) 233.
38 Eilís Ferran, *Company Law and Corporate Finance* (Oxford University Press 1999) 207.
39 Dignam and Lowry (n 1) 141.
40 See also ibid 141.

from the break fee clauses.[41] Courts, in such cases, by examining the parties' intentions will decide whether break fees are an essential part of the M&A agreement, and if so, they will declare the whole agreement void and unenforcable; if not, they will decide to sever this clause from the M&A agreement and enforce the remainder of the agreement.[42]

Finally, in *Paros Plc v. Worldlink Group Plc* case, the Court applied the severability doctrine to the case. The Court established that "*... illegality renders a contract unenforceable rather than void, if by void is meant that the agreement was never made. It is clear that property can pass under an illegal contract, and in some circumstances a Court will enforce a contract which involves an element of illegality. ...*"

The Court also held that break fee clause can be severed from the contract, and the remaining part could be enforced, saying that *"... clause 5.1 providing for payment of a break fee was a contract to do something (viz.* the giving of financial assistance) prohibited by statute. *... it was invalid and unenforceable. Counsel were agreed that clause 5.1 could potentially be severed, and it may well be that the remaining lawful part of clause 5.1 (...) was unaffected."*[43]

CONCLUSION

The prohibition of financial assistance aims to prevent the usage of company resources for external interests and protect the shareholders and creditors of the company. The rationale behind this prohibition is that a company's resources should only be used for the benefit of that company, not to facilitate the acquisition of its shares.

Break fee is a deal protection mechanism that requires that the target company pays the bidder a certain amount of fee if the target doesn't complete the proposed transaction. Break fees aim not only to protect the deal between the parties but also serve other purposes. In terms of the bidder, it enables the bidder to recover its costs arising from due diligence, legal fees, or applications to obtain regulatory approvals to make the transaction. On the other hand, from the target company's point of view, a break fee clause can be regarded as an opportunity enabling the target to reject completion of the deal at a known cost.

The question of whether break fee clauses breach the prohibition of financial assistance is a controversial issue in UK law. Even though break fee clauses look very similar to indemnities, which constitute financial assistance under Section 677, they differ in some aspects. In the event of the dissolution of an

41 ibid 142.

42 Uri Benoliel, 'Contract Interpretation Revisited: The Case of Severability Clauses' (2019) 3 1 The Business & Finance Law Review 90, 94.

43 *Paros Plc v. Worldlink Group Plc* (n 31) [75], [80].

M&A deal, the target pays the break fee regardless of the actual or potential loss to the bidder. Even if the bidder's loss exceeds the break fee, the target isn't under obligation to compensate this exceeding amount. However, indemnifiers are under obligation to fully reimburse the covered loss, and the compensation varies depending on the loss the indemnitee incurs.

In addition, the other reason why break fees can not be regarded as indemnities is the exceptional provision laid down in Section 677. It clearly provides that indemnities given in respect of the indemnifier's own neglect or default do not constitute unlawful financial assistance**.**

It is also necessary to assess whether break fees constitute "other financial assistance". Under Section 677/1(d), unlawful financial assistance is committed, if any other financial assistance given by a company;

a) reduces the net assets of the company to a material extent by the giving of the assistance, or

b) the company has no net assets.

As to whether break fees constitute "other financial assistance" in the light of case law, there is only one example, which is Paros Plc v. Worldlink Group Plc case. In this case, the Court ruled that the break fee clause in the M&A deal is "other financial assistance" and has a material effect on the net assets of the company. According to the Court, "*it is financial assistance because it is a proposed financial payment which 'smooths the path towards the acquisition of the shares' ".* The Court also states that the fee was "smoothing the path to the acquisition of the shares" because it enabled the bidder to incur up to a certain amount of expenditure in progressing the proposed acquisition secure (or virtually so) that it would be reimbursed to that extent if the transaction failed.

To sum up, break fee agreements can be characterized as "other financial assistance" because they "*smooth the path towards the acquisition of the shares".* In this context, if a break fee agreement as "other financial assistance" reduces the net assets of the company to a material extent or the target company has no net assets, unlawful financial assistance occurs under the Companies Act 2006.

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