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Termination fees in mergers and acquisitions ☆

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Abstract

The paper provides evidence on the effects of including a target termination fee in a merger contract. I test the implications of the hypothesis that termination fees are used by self-interested target managers to deter competing bids and protect "sweetheart" deals with white knight bidders, presumably resulting in lower premiums for target shareholders. An alternative hypothesis is that target managers use termination fees to encourage bidder participation by ensuring that the bidder is compensated for the revelation of valuable private information released during merger negotiations. My empirical evidence demonstrates that merger deals with target termination fees involve significantly higher premiums and success rates than deals without such clauses. Furthermore, only weak support is found for the contention that termination fees deter competing bids. Overall, the evidence suggests that termination fee use is at least not harmful, and is likely beneficial, to target shareholders.

JEL classification: G34; K22

Keywords: Mergers and acquisitions; Takeovers; Termination fees; Takeover premiums

SDL would have to pay JDS Uniphase $1 billion if it decides to abandon the merger plan and become part of another company, giving new meaning to the phrase 'breaking up is hard to do – CNNFn, July 10, 2000.

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1. Introduction

Almost two-thirds of the merger agreements announced between 1997 and 1999 included a target termination fee clause. A target termination, or breakup, fee clause requires that the target pay the bidder a fixed cash fee if the target does not consummate the proposed merger. Termination fees are of current interest in the area of mergers and acquisitions in light of the large termination fee recently paid by Pfizer/Warner-Lambert to American Home Products (AHP), following Warner-Lambert's decision to cancel its merger with AHP in favor of a union with Pfizer. Natural questions stem from the publicity surrounding this fee (see, for example, *The Wall Street Journal*, February 7, 2000, p. A3), such as what target managers hope to gain by agreeing to pay a termination fee to the bidder, and in particular whether the use of a termination fee benefits or harms target stockholders on average.

This empirical setting has the potential to contribute to the extensive literature devoted to ascertaining, usually from the stock market reaction, whether decisions made by corporate managers appear to be motivated by "managerial entrenchment" or "shareholder interest." One particularly fertile area for studying entrenchment versus efficiency is mergers and acquisitions, as the act of selling a firm typically entails the selling managers losing their jobs, or at least sacrificing some degree of control. Evidence of behavior indicative of managerial entrenchment or shareholder interests in mergers and acquisitions is mixed. On the one hand, Hadlock et al. (1999) interpret high rates of management turnover following bank acquisitions as evidence that target managers actively oppose takeover attempts, and Chang (1990) finds that firms adopting ESOPs as takeover defenses suffer significant stock price declines, supporting the entrenchment hypothesis. Furthermore, Harford (1999) finds that cash-rich firms are more likely to make diversifying, value-destroying acquisitions with poor post-acquisition performance.

On the other hand, Mulherin and Boone (2000) report evidence of positive wealth effects associated with acquisitions and divestitures, inconsistent with managerial entrenchment. Moreover, Schwert (2000) concludes that target managerial "hostility" towards potential acquirers is associated with outcomes that are most consistent with "strategic bargaining" on the part of target managers, and that this bargaining strategy is beneficial to target shareholders on average. Comment and Schwert (1995) reach a similar conclusion about the adoption of poison pill anti-takeover provisions.

As a target termination fee agreement could be considered prima facie evidence that target managers have distorted the acquisition process to the detriment of their shareholders, the incidence of termination fee use has the potential to provide further evidence on the entrenchment and efficiency hypotheses. In this context, the entrenchment hypothesis presumes that termination fees are effective deterrents to competing bids for the target firm, and therefore allow entrenched target managers to selectively deal with one particular bidder in return for some benefit (for example, job security). The agency cost to target shareholders is the assumed loss of takeover premium resulting from the curtailment of a full auction for the target firm.