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How much is reasonable? The size of termination fees in mergers and acquisitions[☆]

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ABSTRACT

We investigate termination fee size in mergers. Although the deal premium does not significantly affect fee size, smaller targets and targets with lower institutional ownership offer larger fees. Low or moderate fees do not eliminate post-announcement competing bids, while large fees do. Fee size is generally positively correlated with deal completion. However, large fees are negatively correlated with the consummation of high-premium deals. Fee size is generally unrelated to announcement-date cumulative abnormal returns. However, returns are significantly lower for deals including fees larger than 5%. Overall, the study provides evidence that low- or moderate-size fees serve as efficient contractual devices, while large fees are less beneficial to shareholders and therefore tend to suggest agency conflicts.

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1. Introduction

Merger and acquisition bidders face uncertainty in that a proposed deal is vulnerable to third parties who attempt to make competing bids or to target shareholders who fail to approve the transaction. To protect their interests and seek remuneration for their investment in time and due diligence should the deal not be consummated, bidders often request that the targets provide termination fees, which entail a contingent payment to the bidder that is triggered in the event that management of the target abrogates the agreement.¹

Since Ayres (1990) first presented his theoretical model examining the role of lockups, several studies have examined deal protection devices, which protect an initial bid against unwelcome competing bids during the interval period.² Commonly used deal

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¹ Hotchkiss et al. (2005) demonstrate that termination fee provisions are used more frequently on targets than on bidders because targets tend to have more severe holdup problems.

² The interval period is the period (2–4 months) between the signing date and closing date of a deal. The deal is expected to close, after completing shareholder approval, the filing of proxy statements, and registration of securities exchanged in the transaction.

protection devices include, but are not limited to, termination fees, lock-up options, and no-shop provisions.³ Among the studies examining deal protection devices, Coates and Subramanian (2000) use both theoretical and empirical models of lockups and termination fees and focus on buy-side distortions. Officer (2003) and Bates and Lemmon (2003) provide two theories to explain why target managers agree to include termination fee provisions in deal agreements. The first is based on principal-agent theory, suggesting the provisions might be granted by self-interested managers to bidders where offers are in the target managers' best interests (usually because the offer includes job security or a severance package), but not necessarily in the best interests of target shareholders. Since the presence of deal protection provisions may reduce the possibility that competing bidders will make superior bids or reduce the size of the bids that are made, the agency conflict model predicts that the use of termination fees is detrimental to shareholders' interests. The alternative efficient contractual device theory suggests that deal protection devices are used to solve possible contracting problems between bidders and targets in merger transactions. A contracting problem may occur if competing bidders free-ride on information initially revealed by the original bidder. This free-riding is costly for the original bidder. In addition, an initial bidder typically spends significant money and time in evaluating and negotiating with a target. Consequently, target managers may provide termination agreements to encourage the original bidder to reveal more valuable private information and make the investment of time and effort necessary to successfully complete a deal. The efficient contractual device explanation therefore predicts that termination fees are beneficial to target shareholder wealth. Both Bates and Lemmon (2003) and Officer (2003) find empirical evidence that merger deals that include termination fee provisions are more likely to involve greater deal premiums and higher completion rates than deals without such provisions. They conclude that termination fees generally benefit or, at least, are not detrimental to target shareholders.

Although earlier empirical studies make important contributions to furthering our understanding of the role of termination agreements, little research has been done on why target firms offer termination fees at particular levels and on how fee size (as opposed to fee existence) affects deal performance and shareholders' wealth. For example, the empirical models of Bates and Lemmon (2003), Boone and Mulherin (2007), and Officer (2003) utilize a discrete model where target firms are grouped based on whether the termination fee provision is included or not. One exception to this approach is Coates and Subramanian (2000) who analyze the determinants of fee size and report an upward trend in fee size during the 1990s. Coates and Subramanian did not, however, focus on how fee size affects deal performance and shareholder wealth. In addition to reexamining the determinants of fee size, incorporating the changes in deal protection devices that have occurred over the last 10 years, we focus on how the size of fees affects deal performance and shareholder wealth.⁴

The size of termination fees is important for a number of reasons. If the amount of the termination fee is too small, an initial bidder who is not fully protected against possible free-riding by competing bidders is not likely to reveal private information to facilitate the deal process or invest much time or effort in the process. Conversely, unreasonably high termination fees might raise suspicion that target managers are willing to preclude superior competing bids and might lead shareholders to forego a higher premium offer because paying a high termination fee would offset the higher premium in that offer.

In addition, the size of termination fees is important in a legal sense. A higher fee raises the possibility that it will not survive judicial scrutiny because the courts might view it as a coercive measure designed to preclude competing bids (Block, 2007). Generally, the courts have arrived at the conclusion that termination fees ranging from 1% to 5% are reasonable and the fees have been upheld after legal challenges.⁵ In contrast, one court's view was that a termination fee of 6.3% "certainly seems to stretch the definition of range of reasonableness and probably stretches the definition beyond its breaking point" (*Phelps Dodge Corp. v. Cyprus Amex Minerals Co.*, Civ. A. No. 17398 (Del. Ch. Sept. 27, 1999)). Determining whether the courts' instincts in these matters are supported by empirical evidence provides additional motivation for examining the question of whether unreasonably high fees are detrimental to shareholder wealth.

We find that fee size varies significantly with the 75th percentile of dollar fee size being over 11 times greater than the 25th percentile of dollar fee size (\$35 million versus \$3 million). Although percentage variation in fee size is smaller with the 75th percentile of fee size as a percentage of deal value being 50% greater than the 25th percentile of fee size (3.9% versus 2.6%) it is still significant. Given that average deal values exceed the average pre-bid target market values by about 40% in our sample, the percentage variation in fees in terms of pre-bid target market values is even greater. Thus, there is substantial variation in fees both in dollar terms and in the proportion of pre-offer target market value. Given that we might expect informational investment of the bidder to be relatively constant across targets with a given market value, we find the extent of variation in percentage fees somewhat surprising.

³ Coates and Subramanian (2000), Burch (2001), and Boone and Mulherin (2007) report that target managers offer lockup options less than half as often as the termination fees. Under lockup agreements, a bidder obtains an option to purchase target stock or acquire key assets of a target. Lock-up options for target assets became quite rare after the combined effects of the decisions in *Revlon v. MacAndrews*, 506 A. 2d 173 (Del. 1986) and *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A. 2d 1261 (Del. 1989). After the FASB's decision to abolish the pooling accounting method, lockup options for stock have received less judicial scrutiny (Balz, 2003). Hotchkiss et al. (2005) report that about 99% of deals use no-shop provisions, which prohibit the solicitation of additional bids by the target. Historically, the lack of variation across deals has made it difficult to examine the role of no-shops.

⁴ Our sample period is characterized by the introduction of new trends in deal protection techniques including the disappearance of lockup options and emergence of go-shop provisions. In our sample, the use of lockups as a deal protection device significantly decreases after 2001, when the Financial Accounting Standards Board (FASB) prohibited the pooling accounting method, and completely disappears after 2003. On the other hand, a new deal protection device, the go-shop, has been introduced since 2005. This provision essentially reverses the traditional no-shop provisions by allowing targets to actively solicit bids for a limited period of time following the signing of a deal. Go-shops may be "add-on", following a traditional solicitation of bids, or "pure" following an exclusive negotiation with a potential buyer. The latter type of transaction was particularly popular during the private equity leveraged buyout (LBO) boom of 2005–2007 (Subramanian, 2008).

⁵ See, for example, *Kysor Industrial Corp. v. Margaux, Inc.*, 674 A.2d 889, (Del. Supr. 1996).

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