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How much is too much? Large termination fees and target distress[☆]

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ABSTRACT

We provide evidence that large termination fees mitigate contracting problems in acquisitions of targets with high information asymmetry. Large fees are more common if targets face financial constraints or distress. Deals with large termination fees are less likely to be consummated, consistent with large fees allowing acquirers to recover bidding costs when facing a high risk of bid failure. We correct for the endogenous selection of large termination fees and present evidence that managers negotiate large fees in exchange for higher premiums. This is in contrast with prior evidence that suggests large fees result from managerial self-interest and harm target shareholders.

1. Introduction

How much power should a board have to resist an unwanted takeover bid? Acquirers often secure merger agreements with contractual provisions that protect the deal from competing bidders. One such provision, a termination fee, promises a payment to the acquirer if the target breaks the agreement. This payment increases the cost of terminating the deal, which provides an opportunity for self-interested managers to secure an agreement that provides personal benefits and inhibits higher value competing bids. In spite of the potential harm to shareholders, termination fees are common, found in over 90% of bids.[1] Proponents suggest these fees allow acquirers to recover their bidding costs after termination, which provides incentive to sink these costs ex ante and make a formal offer.

Prior research provides evidence on whether termination fees are harmful or beneficial to target shareholders. Bates and Lemmon (2003) and Officer (2003) find that acquirers are willing to pay a higher price to target shareholders in exchange for the greater certainty that termination fees provide. However, Jeon and Ligon (2011) suggest that larger fees (measured as a percentage of deal value) indicate agency problems. The 2014 Comverge case in the Delaware courts epitomizes this criticism. Considering a low bid price and allegations that management received favourable employment packages, the court argued that a fee of 7% of the deal value, in addition to other payments, could create an unreasonable barrier to competing bidders, breaching the target directors' duties to shareholders.[2] However, Comverge's management contended that they faced severe liquidity constraints and had no alternative offers, which created a "perfect storm" resulting in extreme negotiation outcomes.

In this paper, we examine the role of large termination fees in acquisitions, specifically, whether such fees are motivated by managerial self-interest or by the desire to attract the best offer for target shareholders. We first posit that large fees aid in the acquisition of targets facing severe problems of information asymmetry, as proxied by target distress or financial constraints. We focus on these acquisitions, because bidders must invest more relative to the size of the target to learn about the viability of the

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[1] Statistic is from 2011 data. By comparison, other contractual provisions such as lock ups, toeholds, and go-shop provisions are present in only about 0%, 5%, and 10% of sample bids in 2011.

[2] In re Comverge, Inc. Shareholders Litigation, 2014 WL 6686570 (Del. Ch. Nov. 25, 2014).

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target's assets, uncover any undisclosed liabilities, and investigate the claims of other stakeholders on the target's assets. Potential acquirers would be hesitant to sink these substantial costs without the promise of recovery provided by a termination fee.

Agency problems provide another, non-mutually exclusive, explanation for the use of large fees. Conflicts between managers and shareholders are likely heightened in firms experiencing financial difficulty, as managers suffer from poor incentive alignment due to lower pay, out-of-the-money options, and increased turnover risk (Hotchkiss et al., 2008). Due to the increased incentive problems, Roosevelt (2000) posits that managers of insolvent targets have greater incentives to use termination fees to secure agreements with personal benefits such as severance payments or employment with the acquirer.[3]

We find that distress and financial constraints are significant determinants of the choice of large termination fees, defined as fees above 6% of deal value.[4] Targets are more likely to use large termination fees if they are distressed based on CHS scores and Ohlson's O-scores. Similarly, large termination fees are more common in deals for targets that score poorly on common measures of financial constraints–the Kaplan–Zingales index, Whited–Wu index, SA index, and non-investment grade debt. These results are consistent with large fees helping to attract bids for targets that would entail high information-gathering costs.

We also re-examine the relation between bid premiums and large termination fees found in prior research. Bates and Lemmon (2003) and Jeon and Ligon (2011) use cross-sectional analysis and report a large and significant negative association between large termination fees and bid premiums, consistent with managers accepting lower premiums in exchange for personal benefits. We then examine the endogenous nature of this relation and correct for the endogeneity using firms' Delaware incorporation as an instrument. We find a positive, albeit insignificant, relation between premiums and large fees in two-stage least squares estimates after this correction. This result suggests that target shareholders do not fare any worse in bids with large termination fees compared to bids with smaller termination fees.

We further analyse the effect of large termination fees on premiums by using the predicted probability of large fees from a probit regression that uses deal and target characteristics related to distress and contracting costs. We find that higher premiums are related to a higher probability of larger fees, consistent with managers exchanging large fees for higher premiums when such fees are related to contracting and information-gathering costs. Additionally, we use an indicator variable that is set equal to one if managers use a large fee, even though the predicted probability of a large fee is below 50%.[5]

This indicator captures the unexplained component of fees that is not captured by observable economic determinants of large fees. In as much as this indicator variable captures managerial self-interest, our results are consistent with agency-related explanations for large fees, because the indicator is negatively related to deal premiums.

Next, we examine the impact of large termination fees on bid competition. While termination fees increase the cost to the target of abandoning a merger agreement to accept a competing bid, we find that large fee bids are more competitive on average. Completion rates of targets in deals with large fees are 4.9–8.9% lower, and these bids are 5.6–12.5% more likely to attract a challenging bid in multivariate analysis. These results suggest that large fees do not lock in management friendly bidders, but are consistent with bidders contracting for higher fees when competing bids are expected and bidding costs are high.

We find no direct evidence of self-interested managerial bargaining on the part of managers in large-fee deals. Following Hartzell et al. (2004), we study the personal benefits of managers by hand-collecting data on post-acquisition employment and compensation for target managers in large-fee bids and for a matched sample of target managers in bids without large fees. Target managers who negotiate large fees are not more likely to receive greater compensation or employment with the acquirer than a matched sample. The lack of personal benefits is inconsistent with the idea that managers who negotiate large fees face greater agency and incentive problems.

This paper contributes to the existing literature in several ways. Primarily, our results contrast with prior evidence that suggests large fees harm target shareholders. Rather, we show large fees are common in the sale of distressed and constrained targets, i.e., deals in which the costs of bidding are large relative to the size of the deal. This is consistent with prior research showing that target managers use termination fees and, more generally, deal protections to incentivize bidding and increase target managers' bargaining power in negotiations.[6] We similarly add to a broader literature on the motivations for contractual devices and antitakeover provisions. This literature suggests that managerial self-interest or wealth maximisation can motivate defensive measures and restrictions on bid competition.[7] We contribute to this literature by showing that even seemingly excessive protections can be used to maximize shareholder value and aid in the sale of a distressed target.

Our results also complement recent research on the motivations of acquisitions of targets with financial constraints (Almeida et al., 2011; Erel et al., 2015) and distress (Clark and Ofek, 1994; Hotchkiss and Mooradian, 1998; Meier and Servaes, 2014), as well as further studies into the financial motivations of mergers.[8] Due to the evidence that large fees aid in the reallocation of assets of troubled targets, our results also contribute to prior research related to the use of contracts by managers to overcome market frictions (e.g. Chava and Roberts, 2008; Hoshi et al., 1990).

The paper proceeds as follows. In Section 2, we discuss related literature and develop the hypotheses, followed by a description of

[3] The Delaware courts also suggest that large termination fees outside of a "conventionally accepted range," (*Answers Corp.*) result from agency conflicts, unreasonably restrict bid competition, violate managers' duties to shareholders, and push the limits of deal protection beyond its "breaking point" (*Phelps*). In re Answers Corp. Shareholders Litigation, C.A. No. 6170-VCN (Del. Ch. Apr. 11, 2011); Phelps Dodge Corp. v. Cyprus Amax Minerals Co., C.A. No. 17398 (Del. Ch. Sept. 27, 1999). We also note that the Delaware courts generally take a permissive attitude toward smaller termination fees. In In re Cogent, Inc. Shareholder Litigation, 7 A. 3d 487 (Del. Ch. Oct. 05, 2010) the court stated "a termination fee of 3% is generally reasonable." In In re Topps Co. Shareholders Litigation, 926 A.2d 50 (Del. Ch., 2007) the court stated a termination fee of 4.3% is not "likely to have deterred a bidder."

[4] We distinguish between small and large termination fees as fees less than and greater than 6% of deal value, respectively. Our choice of 6% is motivated by prior literature, and our results are generally robust to 5% and 10% definitions. Bates and Lemmon (2003) use a 10% cut-off to study "jumbo" fees. Jeon and Ligon (2011) examine "high" fees in the top third of the distribution, and courts and legal practitioners suggest fees above 6% are unreasonably large (Panagopoulos, 2005).

[5] This cut-off at 50% is admittedly arbitrary, and we check other cut-offs. The results are qualitatively unchanged if we use a lower cut-off at 25%, 10%, or 5%, as well as a 75% cut-off.

[6] Prior literature on termination fees generally supports an efficient contracting hypothesis for typical fees but is critical of larger fees. See Bates and Lemmon (2003), Berkovitch and Khanna (1990), Coates and Subramanian (2000), and Jeon and Ligon (2011). For evidence on efficient contracting with deal protections, see Bulow and Klemperer (2009), Cramton and Schwartz (1991), and Romano (1992).

[7] For managerial self-interest, see Bebchuk and Cohen (2005), Bertrand and Mullainathan (2003), and Masulis et al. (2007). Bargaining power is analyzed in Bates et al. (2008), Comment and Schwert (1995), and Schwert (2000).

[8] Prior literature on the financial benefits of mergers includes Lewellen (1971), Smith and Kim (1994), Palepu (1986), and Devos et al. (2009).