When a Buyer Gets Cold Feet: What is the Value of a Bidder Termination Provision in a Takeover?

also known as "Reverse Breakup Fee"

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What is a Bidder Termination Provision?

- A clause enabling the buyer to abandon the deal for a fee
- Bidders are otherwise constrained in being able to walk away
- The provision eases this constraint
- The bidder pays the target a termination fee if they walk away
- AKA "reverse breakup fee"
- Appear in 20% of public-public deals; worth 3-4% of deal value
- Seem to be increasingly common

Example: Mars Inc. and WM Wrigley Jr Co.

- Announced Apr 28, 2008; closed Oct 6, 2008
- Mars was to pay Wrigley **$1 billion** if it walked away
- Deal value of $23 billion; Termination fee worth **4.35%**
- Termination fee was negotiated by Wrigley's Executive Chair

Our Research Question

"To date, no theoretical or empirical research has addressed the possible explanations for the provision of bidder termination fee clauses in merger agreements..."

Bates and Lemmon (2003)

1. **Why are bidder termination provisions included?**
   - Why only in some deals?
2. **When included, what determines termination fees?**
3. **How do they affect the outcome of M&A?**

A Simple Model

*"The buyer wants to make sure if things really get bad they can walk away. By the same token we want to make sure we're not just giving the buyer a free **option**"*

Anvil Mining [Takeover Target] CEO, Darryll Castle, 2011

A bidder termination provision creates a real option for the bidder on the target's assets

- Underlying Asset is the target under the bidder's control
- Two factors contribute to the value of this option
  1. Time span between announcement and completion
  2. Constraint on the bidder's ability to walk away

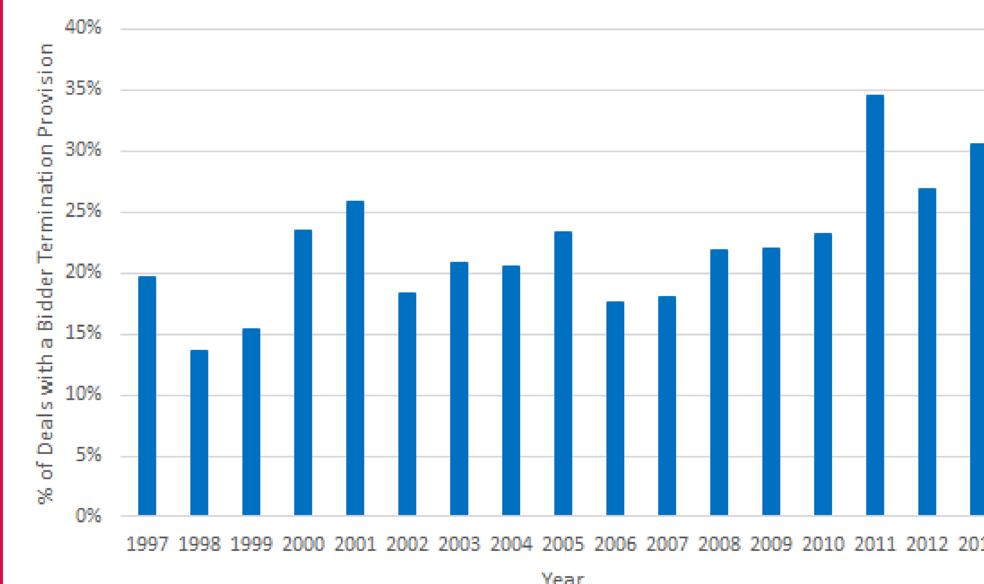
The bidder termination provision creates a tradeoff

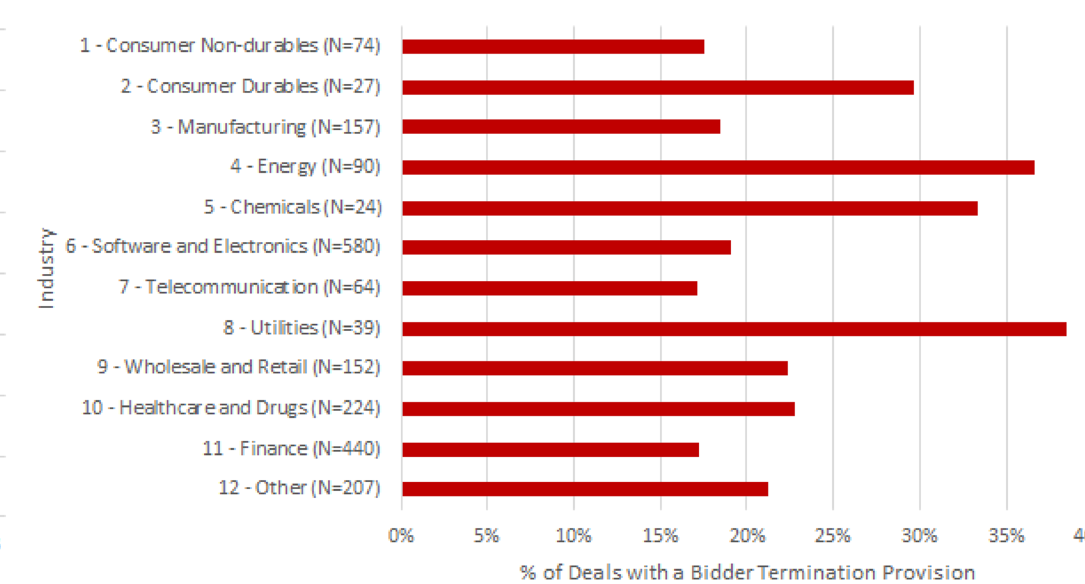
- Termination is good if it occurs when the target is worth less to the bidder than its own
- Termination is bad if it occurs when the target is worth more to the bidder than on its own
- It is included if it is high likely that the target's value to the bidder will fall below the target's stand-alone value
- The optimal bidder termination fee resembles the price of an option with a strike price equal to the offer price

The bidder termination provision creates a real option that can be valuable for both the bidder and target

Data and Sample

- 2078 deals involving publicly-listed domestic bidders and targets, announced between January 1997 and December 2013
- 433 (21%) include a bidder termination provision; termination fee averages 4% of deal value
- 12% of deals are terminated in our sample
  - 6% of deals without a bidder termination provision are terminated by bidders
  - 46% of deals without a bidder termination provision are terminated by bidders





Empirical Results

- We measure the volatility of the value of the target to the bidder using either the bidder or target's asset volatility
- We measure the covariance of the value of the target to the bidder and its stand-alone value using the covariance of the bidder and target's asset values
- We measure the expected completion time using the actual time to completion/withdrawal

1. When is the bidder termination provision included?

$$Provision\ Included = \beta_1 Volatility + \beta_2 Covariance + \beta_3 Completion\ Time$$

- $\beta_1 > 0, \beta_2 < 0, \beta_3 > 0$
- **The more likely the value of the target to the bidder is to drop below the target's stand-alone value, the more likely it is for the provision to be included**

2. What determines the bidder termination fee?

$$\frac{Termination\ Fee}{Deal\ Value} = \beta_1 Volatility + \beta_2 Completion\ Time$$

- $\beta_1 > 0, \beta_2 > 0$
- **Like the price of an option, the size of the termination fee increases in the volatility of the underlying asset (value of target to bidder) and the time to maturity (completion time)**
- Coefficients β_1 and β_2 are stronger when interacted with an indicator for whether bidder termination fees are **not equal** to target termination fees
- **Bidder termination fees are more likely to be properly priced as real options when not equal to target termination fees**

3. What is the impact of bidder termination provisions?

$$Combined\ Return = \beta_1 Improperly\text{-}Priced\ Fee + \beta_2 Properly\text{-}Priced\ Fee$$

- $\beta_1 = 0, \beta_2 > 0$
- **Bidder termination fees can create value for both bidders and targets when priced properly**

Is Signaling an Alternative Explanation?

- Information asymmetry about the bidder's ability or intent to complete the deal may exist
- By committing to pay a costly termination fee a bidder may signal its ``type''; its ability/intent to complete the deal
- This may be relevant in an antitrust context where termination fees can be large e.g. Google Motorola, AT&T T-Mobile

Our analysis does not support this

- Without the provision, withdrawal is **more** difficult for bidders
- Provisions and fees are not related to measures of information asymmetry (e.g. analyst coverage and accuracy)
- Provisions and fees are not related to deal completion

What Do We Learn?

A bidder termination provision can benefit both bidders and targets

- It does not favor just the target or just the bidder
- It can create value that is shared by both parties

Value may be lost if bidder termination fees are priced improperly

- The practice of pricing bidder termination fees equal to target termination fees is inefficient
- Bidder termination fees should be priced independently and account for their real option value

Our framework is applicable to "option-style" provisions as well as provisions with specific triggers

- Though we abstract away from this distinction
- Bidder termination provisions are often triggered when:
  - Credit markets deteriorate and financing becomes costly
  - A regulator intervenes and requires divestitures
  - A superior target emerges, raising bidder's opportunity cost
- These triggers correspond to instances where the bidder's value for the target might drop substantially

Our framework validates the use of the provisions to transfer antitrust risk to bidders

- Bidders are subject a "hell or high water" clause
- Bidders are required to undertake any actions required (e.g. divestitures) to obtain antitrust approval
- Depending on the value of the target to the bidder, the bidder may or may not prefer to comply
- The bidder termination provision gives the bidder the flexibility to make this choice
- This flexibility benefits both the bidder and target