Abstract
We model takeovers as a bargaining process and explain the existence and net effect of target as well as bidder termination fees, subject to bargaining power and outside options. In equilibrium, net termination fees (target minus acquirer fees) are offered by firms with a superior bargaining position in exchange for a greater share of merger synergies. This even holds when the target negotiates with the most efficient bidder and in the absence of bidding-related costs. Using a sample of 1232 U.S. mergers from 1986 to 2003, our theoretical predictions and the concept of net termination fees find empirical support. Net termination fees and premiums are positively correlated, while net fees decrease (increase) in targets' (acquirers') bargaining power, proxied by market capitalization, and increase (decrease) in targets' (acquirers') outside options, proxied inter alia by market-to-book ratios. These results question existing explanations for termination fees and lockup options, like cost compensation, target commitment, agency costs and management entrenchment. They also imply that judicial ruling according to the more lenient business judgement is at least as justified as the application of more restrictive legal standards.