

**Abstract**

We model takeovers as a bargaining process and explain termination fees for, both, the target and the acquirer, subject to parties' bargaining power and outside options. In equilibrium, termination fees are offered by firms with outside options in exchange for a greater share of merger synergies. Termination fees decrease in firms' bargaining power, and increase in firms' outside options. We find that a merger with the second highest bidder, including a termination fee, can lead to equally high premiums as a merger with the highest bidder, without a termination fee. This novel result directly contrasts the agency cost perspective, which argues that termination provisions may be used by managers to lock into acquirers that do not generate the highest shareholder value. Further, even in a merger with the highest bidder and in the absence of bidding related costs, a termination fee is not necessarily a deal protection device, but can be used to improve shareholder value. Our bargaining model offers an alternative to auction related explanations of termination fees, like cost compensation or seller commitment.