"Social" Issues and Reverse Break-up Fees in M&A

The default arrangement in M&A is often for the acquiring executives and board, operating from the acquirer's headquarters, to assume control of the target's assets, which are managed under the acquirer's name. In many transactions, however, this arrangement is also brought to the negotiating table, with the issues of who is going to be the CEO, who will be on the board, what the company will be called, and where the headquarters will be located, all being subject to negotiation. In many transactions, the first items discussed during negotiations are not financial matters but are, in fact, these non-financial issues which are often referred to as ``social" issues. Transactions have reportedly collapsed altogether when the acquirer has failed to give in to the target on social issues. Furthermore, premiums received by targets' shareholders are in turn said to have been sacrificed by the targets' managers in exchange for securing such terms.

In one of my recent papers, I examine social issues in M&A and find that they are explicitly addressed in the deal terms of about 30% of transactions and are not just restricted to "mergers of equals". One insight of my paper is that social issues are detrimental for shareholders of takeover targets, who receive premiums that are up to 10 percentage points lower in deals with terms addressing social issues than other similar deals. The discount that acquirers apply to the purchase price is greatest when targets' executives are to occupy top-management positions in the combined company. While a discounted purchase price may directly benefit an acquirer, it turns out that acquirers also do not do very well in such deals either. Social issues are associated with less favourable market reactions for acquirers around the merger announcements and poorer operating performance in the three years following a merger. Therefore, while social issues may be of interest to transacting parties, my findings suggest that they impede the value creation in M&A.

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In most M&A deals, an acquirer that signs a merger agreement is generally obliged to meet the closing conditions of the transaction, barring extenuating circumstances such as a material adverse change or event involving the target. It is, however, increasingly common for some deals to include a provision giving acquirers the option to walk away under some circumstances, at the cost of paying a "reverse break-up fee" to the target. Furthermore, in deals subject to regulatory concerns, it is common for the acquirer to commit to pay a reverse break-up fee should a regulator veto the deal.

In another recent co-authored study, we build on the conjecture that reverse break-up fee provisions effectively create a real option for buyers to determine when they are desirable to have and what an appropriate fee should be. Essentially, such provisions are more desirable when the value created by a deal is subject to more risk, and when the deal is expected to take longer to complete, and consequently, reverse break-up fees should be larger in such circumstances.

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BIOGRAPHY

AAZAM VIRANI is an Assistant Professor of Finance at the Eller College of Management at the University of Arizona where he teaches an undergraduate Finance course and recently received the Scrivner Teaching Award for the 2015-2016 year. He completed his doctoral studies at the University of Toronto where he began to pursue his research interests in M&A and Corporate Governance and also co-authored a case study on syndicated investment in infrastructure by pension funds. His research has featured at renowned academic conferences and has been cited in media outlets such as *the Globe and Mail* and *the Financial Post*.

TESTIMONIAL

I am deeply honoured and very grateful to the CSIRF for having been awarded the Ph.D. scholarship in 2013 while I was a doctoral student at the University of Toronto. I received the award at a critical time during my studies and it provided a tipping point for several preliminary projects I was working on at the time that subsequently constituted my dissertation. In particular, the financial support from CSI enabled me to attend several academic conferences that helped me further my research and increase its visibility, to obtain data, and to continue to pursue my research agenda uninterrupted.

Our findings suggest that it is more appropriate for acquirers to bear regulatory risk and pay reverse break-up fees when a deal fails to receive regulatory approval, rather than having the regulatory risk shared by both parties. While it is common practice for reverse break-up fees to be equal to the fees that targets pay if they walk away (known as a “break-up fee”), our findings indicate that reverse break-up fees should be priced independently from break-up fees. In fact, we find that reverse break-up provisions can benefit *both* acquirers and targets, provided that the reverse break-up fees are priced appropriately. ■