The law and finance of M&A contracts
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Citation for published version (APA):
Karsten, C. G. J. (2013). The law and finance of M&A contracts

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Introduction and Summary

What role do contracts play in mergers and acquisitions (M&A)? M&A transactions can be complicated because of economic concerns related to information asymmetry, agency problems, and risk allocation. Contract design can provide mechanisms to mitigate these concerns (Gilson (1984)). The empirical question is, however, to what extent contracts are indeed used as instruments to alleviate such concerns? And to what extent do the involved law firms or lawyers also influence acquisition contracts and negotiations?

This thesis will shed light on these questions by analyzing contracts between buyers and sellers from 151 acquisitions of privately held targets. The contracts were obtained from one of the largest law firms in The Netherlands and span the period from 2005 to 2010. These contracts contain detailed provisions used to transfer companies. In addition, they allow us to identify the individual law firms and lawyers advising both buyers and sellers.

The focus is on M&A contracts, as corporate acquisitions are among the most important strategic decisions in the lifetime of a company, requiring large amounts of resources and management time. While most prior literature has focused on public
acquisitions, our sample concerns acquisitions of privately held targets. These are important deals to analyze, as they constitute the vast majority of M&A deals.2

Existing literature has provided various insights to our understanding of mergers and acquisitions. For example, there is substantial evidence on how buyer and seller characteristics, or investment banks, affect acquisition outcomes such as deal completion rates, premiums, or announcement returns.3 However, contracts signed between buyers and sellers have received relatively little attention, even though they form a key element in corporate acquisitions, especially those involving private targets.4 Moreover, considerable fees are paid for drafting and negotiating these contracts.5

This thesis consists of three chapters that address different, but related, aspects of the law and finance of M&A contracts. Chapter 2 describes the drivers of variation in contract provisions across deals. Chapter 3 then relates these provisions to premiums paid. Finally, Chapter 4 considers the role of lawyer expertise on negotiation outcomes, such as contract design and premiums, but also the negotiation process itself.

Chapter 2 studies the extent to which variation in acquisition contracts reflects the economic deal environment, and whether part of this variation can be explained by the styles of the involved legal advisors. Two views can be contrasted on the role of contracts and legal advisors in acquisitions. The first view, as proposed by Coase (1937), holds that contracts are instruments to mitigate economic problems between parties. As a result, the negotiation process should yield contracts which are a pure reflection of the economic

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1 Papers based on M&A contracts concerning mostly public deals have focused on payment mechanisms (Cain, Denis, and Denis (2011) and Coates (2012)), MAC clauses (Gilson and Schwartz (2005), Choi and Triantis (2010), and Denis and Macias (2012)) and on termination fees (Bates and Lemmon (2003) and Officer (2003)).
2 For example, 96% of the cross-border transactions in Erel, Liao, and Weisbach (2012) involve privately held targets. Betton, Eckbo, and Thorburn (2007) document for US takeovers that about 63% of the targets are privately held.
4 An exception is Coates (2012), who studies 60 takeover contracts to assess how relative law firm expertise affects the use of earn outs, price adjustment clauses, and indemnification clauses.
5 Based on UK public deals in 2012, the fees charged by law firms for their services average a substantial 1.3% of deal value, ranging between 0.1% and 4.5% depending on deal size (Freedman (2013)).
conditions of that transaction. This hypothesis forms the foundation to most contract theory, where economic concerns (such as adverse selection, moral hazard, and risk allocation) are optimally addressed contractually, subject only to limitations of complete contracts. In this view, referred to as the economic-contracting hypothesis, legal advisors map an objective contract design to each combination of deal characteristics (Gilson (1984)).

In contrast, the second view argues that contract design is partly driven by the biases or styles of the legal advisors involved in advising on these acquisitions (as suggested by e.g., Coates (2001, 2012), Krishnan and Masulis (2013), and Kaplan, Martel and Strömberg (2007)). This is considered the lawyer-contracting hypothesis. Whereas such influence from legal advisors need not necessarily lead to inefficient contracting, the implications of the drivers of contracting can be important when those contract provisions affect values.

The empirical analysis focuses on two sets of crucial contract provisions – warranties and covenants. Warranties are guarantees that sellers make about the quality of the targets, while covenants restrict seller behavior in the period between the signing of the contract and the transfer of the target. To test whether styles of legal advisors map into contract design beyond objectively applying provisions to an economic environment, we start by analyzing the economic characteristics that drive variation in warranties and covenants. Consistent with the view that contract design can mitigate economic concerns, the results indicate that deals with more information asymmetries between buyers and sellers use more warranties. Similarly, deals that are more prone to agency conflicts rely on more covenants to protect buyers. Moreover, higher buyer bargaining power is associated with better protection, reflected in both more warranties and covenants. Together, these

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6 Warranties and covenants are considered two of the key provisions in takeover contracts. Gilson and Schwartz (2005, p.333), for example, state that “three sets of provisions reflect the three basic engineering elements of a corporate acquisition agreement: representations and warranties, covenants and conditions.” Similarly, Martinus (2005, p.36), claims that “representations and warranties [...] are the primary means to protect the buyer.”

7 Covenants in acquisition contracts are comparable to those in debt or venture capital contracts (see Gompers and Lerner (1996), Kaplan and Strömberg (2003), Murfin (2012), and Bradley and Roberts (2004)).
economic determinants explain 39% of the variation in warranties and 34% of the variation in covenants.\(^8\)

Whereas this suggests that deal economics are relevant in explaining contract design, it also indicates that about two thirds of the variation in warranties and covenants is driven by other factors. To analyze whether the styles of law firms can explain part of the remaining variation, we exploit information on the identity of the law firms that drafted the first versions of the contracts. Law firms generally use firm-specific standardized internal specimens as a basis for new contracts (see Miller (2008) and Coates (2001)). If, during the negotiations, contracts are not fully adjusted to deal circumstances, final contracts will partly reflect these specimens.\(^9\) As such, the identity of the drafting law firms allows us to empirically identify their styles. To test for their impact on contracts, we use law firm fixed effects of these drafting law firms. Supporting the lawyer-contracting hypothesis, we find that these law firm fixed effects are jointly significant and that they modestly increase the explained variation in both covenants and warranties.

Further, if styles of law firms affect contract design, then personal styles of lawyers could also be influential. To empirically identify the lawyer styles, we again focus on the first draft contracts, and consider the lead lawyers who drafted this first version (partner fixed effects).\(^10\) Providing further support for the lawyer-contracting hypothesis, we find that the styles of the individual lawyers also mirror into contract design. Interestingly, it seems that the explanatory power of the lawyer styles is stronger than that of the law firm styles.

To obtain a better understanding of the effect of styles of legal advisors on contracting, two additional analyses are conducted. As a first additional analysis, we assess the impact of these styles on categories of warranties and covenants, where the categories are based on the economic and legal concerns addressed by the provisions. We find that the

\(^8\) Variation explained is represented by the Adjusted R-squared.
\(^9\) The literature on standardization of contracts suggests that contracting parties might not deviate strongly from such specimen contracts due to transaction costs or to avoid enforcement uncertainty (Kahan and Klausner (1997), Gennaioli and Perotti (2010)).
\(^10\) To ensure that law firm styles are held constant, the sample is restricted to contracts drafted by lawyers at the law firm that provided our data.
impact of law firms and lawyers depends highly on the concern addressed by the provision. Some categories are driven mostly by economic conditions, whereas others are related more to styles of legal advisors.\textsuperscript{11} As a second additional analysis, we examine whether observable lawyer characteristics can capture some of these lawyer styles. The results suggest that the style of lawyers in drafting warranties can, to a large extent, be explained by their risk aversion. Conversely, their style in drafting covenants can rather be explained by the business education and corporate experience of drafting lawyers.

Together, the above results highlight the relevance of legal advisors for contract design. An important related question is whether such contract design is reflected in pricing. To analyze this, Chapter 3 investigates whether variation in contract design affects premiums paid. Two opposing views can be distinguished with respect to the relation between contract design and acquisition pricing. The \textit{independence hypothesis} holds that the negotiation process does not allow for interactions between price and non-price terms (i.e. contract provisions), implying that both are determined independently from each other. Conversely, the \textit{feedback hypothesis} argues that the distinct timing of negotiations does not prevent pricing and contract design from being jointly determined, for example, because prices are set in expectation of certain contract provisions that will be included later (Schwartz and Scott (2003), Choi and Triantis (2012)).\textsuperscript{12}

To analyze whether contract design affects pricing, we distinguish between two types of provisions: value increasing versus value distributing provisions. This distinction is interesting, as the impact on premiums could be different for both types of provisions. Value increasing provisions should positively impact the premium, because - for a given division of surplus - an increase in the joint surplus should be split accordingly. In contrast, value distributing provisions could be traded off against each other within a contract, such that they would not affect the price. To reflect the difference in impact, we consider both a

\textsuperscript{11} To illustrate, law firm styles seem to be most influential for warranties and covenants that address concerns which are generally similar across deals, whereas lawyer styles seem to matter more for categories where the interests of the two parties are often misaligned and where value can be distributed.

\textsuperscript{12} This is supported empirically for walk-away rights in public acquisitions by Denis and Macias (2010), Officer (2003), and Bates and Lemon (2003)).
strong and a weak form of the *feedback hypothesis*. The strong form of the *feedback hypothesis* holds that both value increasing and distributing provisions should reflect onto pricing, whereas the weak form suggests that this only holds for value increasing provisions. According to the *independence hypothesis*, neither type should affect premiums.

As value increasing provisions, we consider warranties and covenants, because they reduce adverse selection or moral hazard concerns. As a consequence, they increase the probability of deal completion and prevent costly measures, such as monitoring and screening. As value distributing, we consider provisions that determine the allocation of risk between buyers and sellers. Bearing additional risk imposes costs on one party while benefitting the other, such that these provisions cannot benefit both parties simultaneously. To reflect contractual risk allocation, we consider clauses that limit the scope or enforceability of the warranties, thereby limiting the extent to which warranties provide insurance next to signaling quality. Moreover, as another measure of risk allocation, we consider the extent to which sellers bear the risk of adverse events occurring between signing and closing.

To identify a causal relation between contract design and acquisition pricing, we use an instrumental variables approach. To this end, we build on the findings in Chapter 2 and exploit exogenous variation in contract design that arises as different law firms use different internal specimen contracts as a starting point when advising their clients. If these contracts are not fully customized to deal specifics, then variation in contract design partly reflects variation in the specimen contracts. Therefore, law firm fixed effects, of the law firms who provided the first drafts, are employed as instruments.

The findings in Chapter 3 support the weak form of the *feedback hypothesis*. Both warranties and covenants significantly increase premiums paid in acquisitions, which we measure using the market-to-book value of the target (e.g., López-de-Silanes (1997) and Masulis and Nahata (2011)). This suggests that buyers pay for protection granted against adverse selection and agency concerns with higher prices. In contrast, value distributing provisions do not seem to affect prices. This could indicate that parties do not anticipate
contractual value allocation when they set prices. On the other hand, some value distributing provisions do positively affect premiums in samples where sellers have high bargaining power, for example when they are large relative to buyers. This could suggest that the value of risk-allocating provisions is known, but that sellers need to have high bargaining power to demand compensation for bearing such additional risk.

To obtain a better understanding of the price impact from warranties and covenants, we next analyze whether mitigating some concerns is more valuable than others. To this end, we categorize these provisions according to the concerns they address, as in Chapter 2, and test whether there is heterogeneity in the price impact across categories. We find that the positive effect of warranties on premiums is mainly driven by warranties that relate to target financials and intellectual property rights. Conversely, independent of the covenant category, we find that more covenants relate to higher premiums. However, the strongest impact is driven by covenants on divestments.

Taken together, Chapter 2 and 3 show that styles of legal advisors are important drivers of contract design, and that this contract design has real value consequences. An important next question is, therefore, how the lawyers influence acquisitions? To shed light on this, Chapter 4 investigates whether lawyer expertise is one of the drivers behind lawyer styles, as documented in Chapter 2. As such, lawyer expertise will be related to negotiations dynamics and outcomes in acquisitions.

Analyzing the impact from lawyer expertise on acquisition outcomes is interesting, because -if expert lawyers are indeed better at negotiating contracts- two approaches can be distinguished on how lawyers use their expertise. According to the cooperative-advice hypothesis, the main objective of lawyers is to execute legal elements of a transaction and mitigate any economic issues that arise between buyers and sellers. This view asserts that lawyer expertise is only used to maximize the joint value of both parties (e.g., Gilson (1984) or Mnookin, Peppet, and Tulumello (2000)). In contrast, according to competitive-advice hypothesis, lawyers compete to negotiate outcomes in favor of their own clients’ interests. As a result, lawyers with more legal expertise relative to the counterparty distribute value
away from the opposing parties and towards the own clients. As lawyers, we consider only
the lead lawyers representing the buyer and seller. They oversee all legal aspects of the
negotiations for their clients and are usually partners at their firms.

To test whether these lawyers compete to yield benefits for their own client, Chapter
4 focuses on the impact from a divergence in expertise between the lawyers. To this end, we
create measures of the expertise of the buyer lawyer relative to that of the seller lawyer
(relative lawyer expertise). As proxies for lawyer expertise, we consider measures of both
their experience and education. These expertise measures are then related to negotiation
outcomes where the interests of buyers and sellers are conflicting, such that there is scope
for lawyers to compete in obtaining value for their own client. As negotiation outcomes, we
use proxies for (i) contract design, (ii) the bargaining process, and (iii) acquisition pricing.

The findings in Chapter 4 support the competitive-advice hypothesis, as more relative
lawyer expertise relates favorably to all three types of negotiation outcomes. First, as
proxies for contract design, we consider provisions that allocate risk between buyers and
sellers, because incentives are most conflicting there. We find that more expertise on the
buyer’s side (relative to the seller side) is associated with more risk being allocated to sellers
in the contract design, and vice versa.

Second, expert lawyers are encouraged to influence the bargaining process in their
clients’ favor, as this has implications for both contract design and pricing. Supporting the
competitive-advice hypothesis, we find that more relative legal expertise on the buyer side is
associated with a process that favors buyers. In such deals, the probability is higher that the
buyer can come up with the first draft, leading to a first mover advantage. Moreover, more
buyer expertise is associated with shorter negotiation and shorter closing times (i.e., the
time between signing and closing). Buyers benefit from short negotiations as they reduce
agency problems, save transaction costs, and avoid that the period of exclusive negotiations
expires. Sellers could benefit from longer negotiations as it increases the opportunities to
look for alternative bidders. Similarly, buyers prefer shorter closing times, as sellers keep
control over the target until the closing date, which allows them to extract private benefits.
Third, we find that more legal expertise is associated with more favorable pricing (i.e., lower prices for buyers), also after controlling for the effects of financial advisors and contract design. Whereas lawyers are generally not the primary parties bargaining over acquisition prices, contract negotiations can result in adjustments to initial prices. Buyer lawyer expertise can, for example, result in adjustments if lawyers spot problems in the due diligence that justify a price reduction, or by demanding higher discounts for including seller-friendly clauses. Together, the results in Chapter 4 are consistent with the hypothesis that higher relative lawyer expertise is associated with more favorable negotiation outcomes.

Overall, this thesis underscores the relevance of contracts in financial transactions, specifically in private acquisitions. First, this thesis shows that acquisition contracts show substantial variation across deals and that this variation is partly driven by deal economics. As such, we contribute to an M&A literature on public takeovers, which has focused on drivers of contracts terms such as payment mechanisms and MAC clauses.\(^{13}\) Moreover, this thesis documents that these contracts have value implications that reflect into premiums paid. This highlights that contract design is an important additional, and often unobserved, factor in explaining acquisition premiums. This contributes to an extensive literature that aims at identifying these drivers.\(^{14}\) Third, this thesis emphasizes the influence of legal advisors when advising their clients in M&A. The styles of these advisors affect contract design, bargaining strategies, and acquisition premiums. This contributes to an increasing literature that measures to what extent styles of advisors affect corporate decisions and contracts.\(^{15}\) To conclude, this thesis shows that it is important to integrate a law and finance perspective when studying mergers and acquisitions, as this sheds light on important determinants of M&A outcomes.

\(^{13}\) See e.g., Faccio and Masulis (2005), and Cain, Denis, and Denis (2011)) on payment mechanisms, and Gilson and Schwartz (2005), Choi and Triantis (2010), and Denis and Macias (2012) on MAC clauses.

\(^{14}\) See e.g., Erel, Jang, and Weisbach (2012) for the impact of expected synergies, Aktas, De Bodt, and Roll (2010), and Betton and Eckbo (2000) emphasize bargaining power. And Harford (1999), Masulis, Wang, and Xie (2007), Stulz, Walling, and Song (1990), and Moeller (2005), document an impact from governance.