Motivation:
- Up to now, there exists no direct protection mechanism for target’s intellectual property (IP) during M&A negotiations, and non-disclosure agreements (NDAs) do not fulfill a compensating role if the deal is terminated
- Research Question 1: How can target’s IP be protected during an M&A deal?
- Possible Answer: Create economic incentives for the acquirer to close the deal and/or consider a compensation payment to the target for revealing secret information to the acquirer in case the deal is terminated
- Main idea: Target firm’s valuable IP can be protected from expropriation by the acquirer through negotiating a compensating bidder termination fee (BTF), which is paid by the acquirer to the target in case the former abandons the deal due to reasons under his sphere of control
- Related literature focuses on the inclusion (i.e., determinants of use) of termination fees in M&A contracts (e.g., most recently Chen et al. (2020)), but not on the indirect deviation component and pricing of the BTF
- Research Question 2: How high is this compensation payment as a share of the total amount of the negotiated BTF?
- Central Hypothesis: The higher the value of target firm’s IP, as proxied by its knowledge capital stock, the higher the negotiated BTF

Contribution:
- Identification of an important determinant of indirect costs of deal termination for the target firm as well as the pricing of the BTF
- Creation of a proxy for target’s IP value by applying Evans et al. (2020) capitalization model for intangible capital stocks (accumulated and depreciated R&D and SG&A expenses over the last 10 years prior to deal announcement)
- Instrument variables approach for the main variable of interest (target firm’s knowledge capital stock) to exploit exogenous industry-level variation in R&D worker quota (R&D workers as an important production factor to generate IP)
- Extending Chen et al. (2020), this paper helps to explain drivers of implementing BTFS in merger agreements that arise from a legal, regulatory perspective (e.g., if the proposed deal results in a highly concentrated industry)

Main Findings:
- Target firm’s IP value is strongly positively related to both the inclusion and the absolute and relative size of the negotiated BTF
- A one-standard deviation increase in target’s knowledge capital stock is associated with a statistically and economically significant 0.57% increase in the size of the BTF, whereas BTF size is measured as the dollar value of the negotiated BTF scaled by target firm’s market capitalization (the average BTF size is 1.73% in the sample, and 1.23% when scaled by deal value instead)
- On average, for every dollar of target firm’s R&D capital stock, roughly 16 cents of protective share is incorporated in the BTF
- The relation between target firm’s innovation activity and BTF size is increasing in the degree of technological proximity (Bloom et al. (2013)) and product market rivalry (Hoberg and Phillips (2010, 2016)) between acquirer and target

Robustness Tests:
- Subsample Tests: Relation is more pronounced, if the target is a pioneer in its technology sector, operating in an industry that sells unique products, is assigned to the hightech or healthcare industry, and if the target mentions “trade secrets” in its 10-K report filed with the SEC prior to announcement
- Relation holds independent of scaling method, missing R&D dummy, and degree of information diffusion from target to acquirer (at least quadratically dimension

Tgt Knowledge Capital Stock as a proxy for IP shows a persistently strong correlation with patent value and patent count (Kogan et al. (2017))

References:

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