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# ARE M&A CONTRACT CLAUSES VALUE RELEVANT TO BIDDER AND TARGET SHAREHOLDERS?

John C. Coates<sup>a</sup>, Darius Palia<sup>b,c</sup> and Ge Wu<sup>b</sup>

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## Abstract

Merger and acquisition deals are governed by merger contracts which are negotiated between bidder and target in order to communicate deal terms, specify risk sharing between the parties, and describe dispute management provisions in case of litigation. In a large sample of manually collected U.S. deal contracts involving publicly traded bidders and targets, we construct indices of M&A contract clauses based on legal scholars' and practitioners' *a priori* predictions and examine the relationship between announcement returns and different types of clauses. We find that bidder protective clauses correlate with higher bidder returns while target protective clauses and pro-competition clauses correlate with higher target returns. We also find that bidder and target protective indices have larger impacts on announcement abnormal returns for "bad" deals than for "good" deals, using empirical proxies for deal quality from prior finance research. Finally, we find that the inclusion of more bidder protective clauses leads to lower deal completion rates while the inclusion of more target protective clauses and pro-competition clauses has no impact on deal completion rates. These results are consistent with the expert lawyer/efficient contracting view of Cain, Macias, and Davidoff Solomon (2014), and Coates (2016), and against M&A contracts as immaterial boilerplate agreements.

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## I. Introduction

A large financial economics literature<sup>1</sup> has found that shareholders earn significant abnormal returns over the market on announcement of a merger and acquisition (M&A) transaction. These studies have found that target shareholders earn positive abnormal returns of between 20 percent and 35 percent, whereas bidder shareholders on average earn zero to small negative abnormal returns. However, every M&A deal is governed by a set of contract terms that are described in detail in an agreement filed with the SEC. These M&A contract clauses are negotiated between the bidder and target in order to communicate deal terms, specify risk sharing between the parties, and describes dispute management provisions in case of litigation (see Coates 2015 for a detailed description of these clauses).

This paper examines the impact of M&A contract clauses on the abnormal returns earned by target and bidder firms, respectively. In doing so, this paper makes five contributions. First, we manually collect detailed information for a large set of M&A contract clauses for 819 U.S. publicly traded target firms for the period 2001-2011. Second, based on legal scholars' a priori predictions we create three M&A contract clause indices,<sup>2</sup> namely the "bidder protective clause" index, the "target protective clause" index, and "pro-competition clause" index, which encapsulate many clauses negotiated by lawyers in M&A contracts. Such clauses include are reverse termination fees, termination fees, termination dates, material adverse change (MAC) clauses, match rights, buyer financing conditions, buyer shareholder approval conditions, go shop provisions and walk away rights. Third, we examine if our indices are related to abnormal returns earned by target and bidder firms, respectively. Fourth, we examine if our indices are related to

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<sup>1</sup> See the surveys of Jensen and Ruback (1983), Jarrell, Brickley and Netter (1988), Andrade, Mitchell and Stafford (2001), and Bruner (2002).

<sup>2</sup> See Section II of this paper for detailed description of the clauses and the indices we used to capture them.

the probability of deal completion. And finally, fifth, we examine if there is a differential effect on the relationship between our clause indices and abnormal returns for stock and cash financed deals, which prior finance research has found typically generate different average abnormal returns.

There are two opposing *a priori* views on the expected relationship between M&A contract clauses and the abnormal returns earned by target and bidder firms. On the one hand, such clauses might not have any significant effect on the abnormal returns as they are immaterial “boilerplate” agreements “churned” by overpaid lawyers (see Manns and Anderson (2012), and Manns and Anderson (2016)). On the other hand, such clauses might have a significant effect because they are drafted by expert lawyers in meaningful contracts that modify or make more precise background laws to fit each individual deal. Prior research has shown that contract language evolves in reaction to new case law or statutes or financial risks, or by learning from the ‘best practices’ of other deal lawyers (see Cain, Macias, and Davidoff Solomon (2014), and Coates (2016)), consistent with M&A contracts having a meaningful impact, but these prior studies have not examined stock market reactions to M&A contracts.

We also examine if these M&A contract indices have a differential effect among “bad” and “good” deals. We use an ex-ante definition of “good” and “bad” deals based on prior finance research (e.g., Chang 1998; Betton et al. 2008; Eckbo et al. 2018), which has consistently found positive stock market reactions to cash-funded deals, and negative stock market reactions to large stock-funded deals. Specifically, we define a “good” deal as transaction involving the use of all cash as the medium of exchange, and all other transactions as “bad” deals.<sup>3</sup>

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<sup>3</sup> Consistent with previously documented declines in the use of all stock in deals in the 2000s, e.g., Eckbo et al. 2018, we do not have enough deals that involve the use of stock only as the medium of exchange to examine them separately.

We find the following results. First, we find that bidder protective M&A contract clauses increase the bidder's abnormal returns. Second, we find that target protective clauses increase the target's abnormal returns. Third, we find that pro-competition clauses result in higher abnormal returns for targets, but have no significant effect for bidders. These results show that M&A contract clauses have a significant impact on the abnormal returns of bidder and target firms, consistent with the expert drafting view of Cain, Macias, and Davidoff Solomon (2014) and Coates (2016), and inconsistent with the "churning" view of Manns and Anderson (2012), and Manns and Anderson (2016).

Fourth, we find that buyer protective clauses decrease the probability of deal completion, whereas the target protective and pro-competition clauses have an insignificant impact on the probability of deal completion. Fifth, we find that the bidder and target protective indices to be more positively related to abnormal returns for "bad" (all or part stock funded) deals than for "good" (all cash funded) deals. Additionally, we find that the effect of pro-competition indices on target abnormal returns is on average larger for "good" deals than for "bad" deals but the difference is not statistically significant at usual cutoff levels.

A few studies have examined the impact of a single M&A contract clause on bidder and/or target abnormal returns, as discussed in Section III below. But Coates (2015) points out that many contract terms are typically chosen together in a package of negotiated terms. Accordingly, we differ from this literature in the following ways. First, we create indices so as to aggregate the impact of a number of clauses that on *a priori* grounds capture the same economic effects. Second, we manually collect clauses whereas prior studies use SDC data. We find that SDC often has incorrect information about specific M&A contract clauses. Third, we have included data on clauses which become more common in the 2000s (for example, go shop provisions and match

rights provisions), and in some cases incorporate more details about a given clause (for example, fee triggers for termination clauses and reverse termination clauses).

This paper proceeds as follows. Section II provides background information on three groups of M&A contract clauses and Section III explains the related literature. Section IV describes our data and index construction. Our empirical results are reported in Section V, and Section VI presents our conclusions.

## **II. Value-Relevant M&A contract clauses**

In this section we explain in detail the value-relevant M&A contract clauses and how we create three indices that are based on legal scholars' and practitioners' *a priori* predictions.<sup>4</sup> Table 1 summarizes the definitions of all value-relevant M&A contract clauses and the three merger clause indices.

\*\*\* Table 1 \*\*\*

### **II.A Bidder Protective Clauses**

Bidder protective clauses address two types of risks. First, if the target is less valuable than what the bidder initially expected and there are other deals or uses of time or capital that are superior to the current transaction, such clauses can give the bidder a right to walk away from the deal. Second, if financing terms, regulatory approval conditions, time to deal completion or other deal-related risks turn out to be worse for this deal than what bidder initially expected, the bidder

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<sup>4</sup> We create indices for three reasons. First, many of the clauses are jointly drafted to address similar deal and litigation risks. Second, many of the clauses are correlated, making interpretation of their individual effects difficult. And third, some clauses are used sparingly, resulting in low statistical power for testing significance.

can use these protective clauses to abandon the deal. Bidder protective clauses include efficiently designed reverse termination fees (henceforth, referred to as RTFs), longer termination duration, financing conditions, bidder shareholder approval, and MAC clauses with greater coverage and fewer exclusions.

RTFs are provisions in M&A contracts that (in general terms) permit a bidder to terminate a proposed acquisition of a target firm for a fixed fee. RTFs can be efficient if they specify risks and allocate them to the party best able to bear that risk, and if the other deal terms (including price) reflect that risk allocation. The “price” of a risk allocated through an RTF would in theory be optimally based on estimates of the probability and the cost of realization of that risk. But contract terms are sometimes drafted based on non-analogous precedents, or crude or stale estimates of probability and cost of risks. Such terms can even be ex ante efficient by reducing negotiation costs, but exhibit path dependence and result in terms that are ex post value loss.

To empirically model these possibilities, we draw on prior theoretical work by others. First, we define an “inefficient” RTF based on the size of the fee (based on, e.g., Afsharipour (2010), Quinn (2010), and Coates Palia and Wu (2017)), classifying an RTF with a smaller or equal size than a TTF as “inefficient.” Second, again drawing on prior theoretical work (Quinn 2010; cf. Wulf 2004), we define “inefficient” RTFs if they include triggers that do not reflect exogenous risk (such as regulatory review), but instead reflect (and may add to) agency costs on the part of the buyer managers. We then define an “efficient” RTF as the one with fee size higher than a TTF and without a fiduciary out trigger in a cash deal or a non-MOE stock deal, and include efficient RTFs in our buyer-protective index.

The termination date – sometimes known as a “drop-dead date” – in an M&A contract is the date both parties specify in the termination section of the agreement. We define termination

duration as the number of days between deal announcement and that specified termination date. This is the time period both parties are committed to the deal. Both parties have the right to walk away from the deal if they have not consummated it by the termination date. For a “good” deal, as defined above, a longer duration should be beneficial to the bidder as it gives the parties more time to get the deal done, and prevents a target from walking away for a longer period of time. However, having a longer duration for a “bad” deal gives a bidder more exposure to deal failure risks and should mitigate the cost of the deal to the bidder. We include above-median duration as bidder-protective in good deals, and below-median duration as bidder-protective in bad deals.

A financing condition is a condition to the bidder’s obligation that lets the bidder refuse to close the deal unless the bidder is able to get enough financing to fund the deal. These conditions were once common in cash deals, became increasingly uncommon in the 2000s, but do appear in some deals in our sample. They are straightforwardly protective of bidders.

For the tender offer deals, having shareholder approval rights in the bidder condition section of a merger agreement offers protection for the bidder’s shareholders, who can refuse to vote for deals that harm bidders. Such clauses thus protect bidders. Such clauses are required by law for certain deal structures and methods of payment, but parties have some flexibility to choose deal structures and methods of payment to avoid (or not) the requirement to have such a clause.

MAC clauses permit a bidder to cancel the deal, without penalty, if a material adverse event (MAE) occurs between the deal announcement and completion. MAEs can include changes in the target’s financial condition, the target’s or bidder’s ability to close the deal, or other events. The bidder’s exit right encourages the target to disclose potential MAEs prior to the signing of the M&A contract, and to make synergy investments that would enhance the value of the combined entity. Gilson and Schwartz (2005) show that MAC clauses protect the bidder and allocate



endogenous risk to the target. We use the ratio of MAC coverage to the sum of MAC coverage and MAC exclusions, drawing on prior detailed empirical work examining the content of MAC clauses by Talley (2009).

## **II.B Target Protective Clauses**

Target protective clauses include termination duration, MAC exceptions and walkaway clauses. They protect the target under different adverse events specified in the contract terms.

A longer termination duration will keep both parties committed to the deal for a longer horizon, making it less likely that the deal will fail due to failure to satisfy required conditions before the termination date in the contract. Once the deal is signed, the target has a strong interest in trying to keep the deal intact, as it is to receive a more or less certain premium, and are likely to suffer reputational and operational harm if a deal fails.

MAC exception events limit the strength of a bidder's abandonment option. The exceptions specify events that will not be deemed MAEs. They commonly include a change in trading price or volume of company's stock, changes in interest or exchange rates, war, terrorism, acts of God, political volatility, legal change, national and international calamities, industry- or economy-wide shocks. Gilson and Schwartz (2005) argue that they protect the target and impose exogenous risk on the bidder. Again, we draw on Talley (2009) for our empirical specification of MAC exceptions.

Walkaway clauses provide the target the ability to walk away if there is a specified (typically large) drop in the bidder's share price. The level of price drop is typically measured as a specified percentage decrease from the bidder's stock price at deal announcement, or a relative decrease to an index. They protect the target's downside risk when the bidder uses stock as its deal currency.

## II.C Pro-competition Clauses

Pro-competition clauses manage the bidding and deal negotiation process. They either give the target rights to solicit or consider competitive bids, or give the initial bidder rights to match superior third party offers. Competitive-bid “outs,” go-shop clauses and match rights fall into this category.

M&A contracts commonly give targets the explicit right to terminate a deal in order to accept a competitive (“topping”) bid if received prior to a shareholder vote. Such “competitive-bid” outs thus enhance the risk that competition will emerge after an initial deal is announced. TTFs are compensatory payments made by the target to the bidder if the target terminates for specified reasons. Most TTFs are triggered if the target’s board decides that a proposed third party offer is superior to the current deal before the vote of the target’s shareholders. Using SEC filings that correctly identifies the incidence of termination fee clause, Boone and Mulherin (2007) provide evidence that TTFs enhance rather than impede takeover competition, while Coates and Subramanian (2001) provide evidence that deals with larger TTFs are less likely to face competition and more likely to be completed. Caution should be used in interpreting standard empirical models of the effects of TTFs, however, since they almost always accompany competitive-bid outs. Competitive-bid outs directly permit targets to terminate an initial deal and so should on their own make competitive bids more likely, *ceteris paribus*, while TTFs directly require the target to pay money to the initial bidder and so should on their own make competitive bids less likely, *ceteris paribus*. TTFs effectively add a cost to the use of a competitive-bid out. If that cost is not strictly greater than the expected gain to competitive bidders, the net average effect of the two provisions should be pro-competitive.

Go-shop provisions become an important innovative deal-making technology during the private equity boom of 2005-2007. With this affirmative right, the target has thirty to fifty days to find a topping bid after announcing the deal. Subramanian (2007) examines the effects of go-shop provisions and shows that they yield more aggregate search, significant post-signing competition, and slightly higher returns to target shareholders than traditional no-shop deals. This finding is consistent with the view that a go-shop clause is an efficient contract design which reflects enhanced bidding competition and works to the target's advantage.

Match rights provide an initial bidder a cushion of time and detailed information about any competing bid before the target is permitted to terminate the initial deal and pursue a superior offer. Such rights place the initial bidder in a superior position relative to the subsequent bidders. Quinn (2011) argues that reasonable uses of match rights may reduce the initial bidder's uncertainty costs and induce it to make transaction-specific investments.

## **II.D Value-Relevant M&A Contract Clause Indices**

In section II.A-C we provide detailed descriptions of all the value-relevant M&A contract clauses and divide them into three groups based on legal scholars' and practitioners' a priori predictions. In this section, we describe how we build an aggregate index for each group of M&A contract clauses in the spirit of the Entrenchment Index created by Bebchuk, Cohen, and Ferrell (2009). For most of the clauses, we add one point to the relevant indices for its existence. These clauses include financing condition, buyer shareholder approval, match rights, go-shop clauses and walkaway clauses.

In other cases, the inclusion of terms in the indices is more tailored to their contents: RTFs, termination duration, MAC clauses, MAC Exclusions and TTFs. As noted earlier, we draw on

analysis in Coates Palia and Wu (2017) to divide only code “efficiently” designed RTFs as one of the bidder protective clauses. We give one point to the bidder protective index for the presence of such an RTF, but not for other RTFs.

Termination duration has different impacts on the bidder and the target shareholders, as discussed in Section II.A and B. We calculate the median termination duration and label a deal as having a longer (shorter) termination duration if its termination duration is greater (less) than the median. As we explain above, a longer termination duration is bidder protective for a “good” deal and we add one to the bidder protective index if a “good” deal has an above-median termination duration. A shorter termination duration is protective both bidder and target for a “bad” deal and we add one to the bidder protective index and the target protective index if a “bad” deal has a below-median termination duration.

Legal scholars such as Gilson and Schwartz (2005) have suggested that MAC clauses protect the bidder and MAC exclusions protect the target. We follow Talley (2009) and use MEPerc as our MAC-related measure, which measures the total number of MAC/MAE provisions relative to the total number of provisions (MAC/MAE provisions plus exceptions), as a proxy for MAC clauses and its exclusions. MEPerc is a convenient scoring rule, as it is bounded theoretically below by zero and above by (approximately) one, facilitating construction of our indices. We add MEPerc to the bidder protective index and add  $(1 - \text{MEPerc})$  to the target protective index.

For TTFs we code the existence of TTFs triggered by competitive bid outs and add a one to the pro-competition index, for reasons discussed above.

### **III. Related literature**

The prior literature on value-relevant M&A contract clauses is limited. A few articles examine the relationship between an individual merger clause and bidder or target abnormal returns but none attempt to examine those returns and an index of multiple terms. Officer (2003) and Bates and Lemmon (2003) show that TTFs are efficient contract terms in the sense that they result in higher deal premiums, deal completion rates and target CARs. Bates and Lemmon (2003) also find that RTFs are used to secure a fraction of target wealth gains in deals with higher negotiation and bid failure costs. Mahmudi, Virani and Zhao (2016) suggest that RTFs are real options on a firm's assets and they find that the abnormal returns of the combined firm are higher when the bidder's termination fee is not equal to the target's termination fee. Coates, Palia and Wu (2017) find that RTFs can be inefficiently designed, send a negative "signal" to the market regarding future acquisition odds, or both, resulting in lower bidder abnormal returns.

Many papers examine individual M&A contract clauses but do not relate them to bidder or target abnormal returns. Denis and Macias (2013) argue that MAC clauses have an economically important impact on the takeover dynamics. They show that deals with fewer MAC exclusions are associated with higher arbitrage spreads and deal premiums. Legal scholars also examine some of the protective or pro-competition provisions such as MAC clauses (Gilson and Schwartz, 2005), go-shop clauses (Subramanian 2007) and match rights (Quinn 2011).

Our paper contributes to this literature in the following ways. First, we systematically examine the overall wealth effects of M&A contract clauses by creating indices of value-relevant M&A contract clauses. Second, we use manually coded data from SEC filings to better identify merger contract provisions, rather than relying on Thomson's often incomplete or inaccurate contract clause data. Third, we explore ways in which such clauses can have differential effects

in different kinds of deals, particularly those that are expected a priori to generate negative and positive average stock price reactions. Fourth, unlike most prior event studies of merger contract provisions, we examine reactions to contract filing dates, rather than deal announcement dates, which typically precede filing and disclosure of specific contract terms by one and sometimes as many as four business days.

#### **IV. Data and Value-Relevant M&A Contract Clause Indices**

##### **IV.A Data**

We begin creating our sample of merger and acquisition deals by examining Thomson Securities Data Company's (SDC) Domestic Merger Database from January 2001 through December 2011. This results in 109,098 observations. We drop any transactions where we could not obtain stock return data from the Center for Research in Security Prices (CRSP). This results in an initial sample of 8,488 observations. We then examine SDC for these transactions. We drop deals where SDC show the name of the acquirer to be the same as the name of the target as in parent-subsiary mergers (6,681 observations), and when SDC show the form of the deal not to be a merger as in the case of equity carve outs (281 observations). For this remaining sample we go to SEC's Edgar database in order to obtain the firm's Form 8K. We find 280 deals where we could not find the firm's Form 8K. Among those that we find, 351 observations do not have merger agreements. This results in a sample of 895 transactions. We then manually examine the merger agreements and supplement each one with stock return data to create our independent variables. By this process we lose 76 transactions resulting in a final sample of 819 transactions. A summary of our data collection methodology is given in Table 2.

\*\*\*Table 2\*\*\*

## IV.B Value-Relevant M&A Contract Clause Indices

Panel A of Table 3 contains descriptive statistics for value-relevant M&A contract clauses indices. The average level of buyer protective index is 0.61 with a standard deviation of 0.53. On average, the value of pro-competition index for our sample is 1.85 with a standard deviation of 0.43. The average level of target protective index is 1.43 and its standard deviation is 0.57. Panel B of Table 3 shows the raw correlation between these three indices. All these pairwise correlation coefficients are very small ( $<.06$ ), consistent with our *a priori* expectation that clauses assigned to different indices address different types of risk.

Panel C of Table 3 provides descriptive statistics of individual M&A contract clauses which are the components of these indices. TTFs triggered by competitive bid outs (97%) and match rights (86%) are quite common provisions, which explains the high average level of pro-competition index.<sup>5</sup> Financing condition (9%) and buyer shareholder approval (1%) are rare in our sample, so that it is efficient RTFs (14%) and MAC clauses (with an average MEPer score of 0.32) that are the primary drivers of the buyer protective index. Among target protective clauses, 16% of the deals have walkaway provisions and the proxy for MAC exclusions (1-MEPer) has an average value of 0.68 for our sample deals.

\*\*\*Table 3\*\*\*

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<sup>5</sup> Given that TTFs are almost always present in all contracts, we also created pro-competition index wherein we do not include TTFs. None of our qualitative results change when we do so (results not reported but available from the authors).

## V. Empirical Results

### V.A Abnormal returns

In Panel A and C of Table 4, we calculate the mean and median bidder's and target's daily abnormal returns around the merger agreement filing date. Market participants can only evaluate RTF terms when they have access to the merger contract. In our sample, 19% of the merger agreements are filed with the SEC at least two days after the deal announcement date. To address this issue, we use the merger agreement filing date as the event day, rather than deal announcements, as is more common in M&A-related event studies.

In Panel B and D, we report two sets of bidder and target cumulative abnormal returns (CARs). These sets are one day before and one day after the merger agreement filing date (CAR [-1, +1]), and three days before and three days after the merger agreement filing date (CAR [-3, +3]), respectively.

#### \*\*\*Table 4\*\*\*

Consistent with most prior research, in Table 4, we find statistically significant negative average abnormal returns for bidders, and positive average abnormal returns for targets, in a variety of event windows. In Panel A, we find negative bidder returns in the period [-1, 0] around the merger agreement filing date. Roughly 59% of our sample deals have negative filing date announcement returns, using that window. In Panel B, we find that average and median bidder CARs for [-1, +1] and [-3, +3] are negative and statistically significant at the one-percent level. In Panel C, we find statistically significant positive target abnormal returns in an event window around the merger agreement filing date in the period [-3, +1]. In Panel D, we find that the average and median target CARs for [-1, +1] and [-3, +3] are positive and statistically significant at the



one-percent level. In the analysis that follows, we focus on the CAR [-1, +1] window as our main dependent variable, and use the CAR [-3, +3] window as a robustness test.

## **V.B Abnormal returns and Value-Relevant M&A Contract Clause Indices**

We then examine the effects of the three types of M&A contract clauses on announcement CARs. In Table 5 we present regressions of bidder and target three-day period [-1, +1] announcement CARs on three M&A contract clause indices, with deal and firm characteristic variables as controls.<sup>6</sup> In row (1), we find that a one standard deviation increase in bidder protective index value results in an increase in bidder announcement CARs of 1.01% ( $0.53 * 1.91\%$ ). That translates into a shareholder wealth gain of \$25.3 million for a median sized acquiring firm. This result is statistically significant at the 1% level. We do not find any evidence that target protective and pro-competition indices have impacts on bidder returns.

In row (2), we estimate a more fully specified regression model. We add proxies for agency costs. These include the firms' free cash flow (*fcf\_tgt* and *fcf\_acq*) and the fractional ownership of the managers (*tgt\_insiderown* and *acq\_insiderown*) prior to the bid. We also include proxies for information asymmetry between targets and bidders -- the firms' market-to-book ratios (*mkttobk\_tgt* and *mkttobk\_acq*) prior to the bid. The coefficient on bidder protective index remains positive and the significance level is unchanged.

With these controls, we find weak evidence that deals with higher value of target protective indices have lower bidder announcement CARs. This may be driven by the fact that deals with higher number of MAE exclusion events limit the bidders' walk away rights and therefore lead to lower bidder returns. But we still do not find any value effect of pro-competition clauses on bidder returns.

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<sup>6</sup> None of our qualitative results change when we include a dummy variable for deal completion. Results are not reported but available from the authors.

In row (3) and (4), we summarize regressions of target announcement CARs on M&A contract clauses indices and various control variables. We find that a one standard deviation increase in target protective index value results in an increase in target announcement CARs of 1.88% (0.57 \* 3.29%). That translates into a shareholder wealth gain of \$4.41 million for a median sized target firm. This result is statistically significant at the 10% level. We also find that a one standard deviation increase in pro-competition index value results in an increase in target announcement CARs of 2.93% (0.43 \* 6.82%), which translates into a shareholder wealth gain of \$6.89 million for a median sized target firm. This result is statistically significant at the 5% level. All of these findings are consistent with the hypothesis that deal lawyers negotiate M&A contract clauses that matter, including in many deals bidder protective clauses that benefit bidder shareholders and target protective clauses and pro- competition clauses that benefit target shareholders.<sup>7</sup>

Among the control variables, the signs are similar to those found in many previous studies of merger announcement returns, although some are insignificantly different from zero. Deals with higher percentage of cash as their currency have higher announcement period returns. Announcement CARs are lower if the target firms' sizes are higher comparing to the bidder firms' sizes.

\*\*\*Table 5\*\*\*

In Table 6, we run the same set of regressions using a longer event window [-3, +3] around the merger agreement filing date to test the robustness of our results. We find that all our results of Table 5 hold, but are slightly stronger in both economic and statistical terms.

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<sup>7</sup> All our qualitative results hold when we include E-index in our regressions (results are not reported but are available from the authors).

\*\*\*Table 6\*\*\*

## **V.C Deal Completion Probability and RTFs**

In Table 7, we estimate Probit models wherein the dependent variable is if the deal was completed or not. To the extent that bidder protective clauses give the bidder's option to abandon the acquisition, we expect the value of bidder protective index to be negatively associated with the probability that the acquisition is completed. Consistent with our prediction, the results in row (1) and (4) indicate that having more bidder protective clauses significantly lowers deal completion rates. A one standard deviation increase in the value of bidder protective index results in a negative 15.2% change in the probability of completion. This result is statistically significant at the 5% level. This result is consistent with bidder-protective clauses actually mattering to bidder choices, and in line with the market reactions reported above.

By contrast, the results in row (2) and (4) suggest that pro-competition clauses do not truncate the natural bidding process by letting self-interested target managers to hand-select friendly bidder in exchange for a side payment. Nor do we find evidence, with respect to target protective clauses, that including such clauses lowers the deal completion rates. Our interpretation for this result – together with the positive CARs we report above -- is that pro-competition and target protective clauses to an extent reflect a robust pre-announcement shopping process, and greater bidder commitment to the deals in which they are included. Those deal features are private information prior to deal announcement, resulting in CARs. But the provisions are present in deals where they are unlikely to matter, resulting in non-results in our deal completion models.

\*\*\*Table 7\*\*\*

#### **V.D Subsample Analysis: Abnormal returns and Value-Relevant M&A Contract Clause Indices in “Good” and “Bad” deals**

To further test the robustness of our results, we separate our sample into all cash deals and stock deals. If M&A contract clauses matter as hypothesized above, we would expect the bidder and target protective indices to be more positively related to abnormal returns for “bad” deals than for “good” deals. Additionally, we would expect the pro-competition indices to be more positively related to abnormal returns for “good” deals than for “bad” deals. Our assumption for this subsample analysis is that deals using stock as deal consideration are more likely to result in value destruction, consistent with prior research and our average stock price findings reported above.

In Panel A of Table 8, we find that among stock financed deals, deals with more bidder protective provisions are associated with significantly higher bidder announcement CARs while deals with more target protective provisions and pro-competition provisions are associated with significantly higher target announcement CARs. In Panel B of Table 8, we find that among all cash financed deals, bidder protective clauses have no impact on bidder shareholder wealth while target protective clauses have negative impact on target shareholder wealth. We also find that the pro-competition indices are associated with higher target abnormal returns.

In Panel C of Table 8, we report the differences of regression coefficients on M&A contract clauses indices between stock financed deals and all cash financed deals. Consistent with the hypothesis that M&A contract clauses matter in intuitive ways, making deals more or less likely to close, we find that the bidder and target protective indices have larger value impact for “bad” deals than for “good” deals. We find the effect of pro-competition indices on target abnormal returns is on average larger for “good” deals than for “bad” deals but the difference is not at a statistically significant level at the usual cutoff level.

We interpret these results as being consistent with bidders being able to and having an incentive to walk away from “bad” deals when they have negotiated for bidder-protective contracts, while being less able to do so in deals with target protective and pro-competition clauses. By contrast, in “good” deals, contract clauses matter less to bidders, because they have less of an incentive to rely contract protections to walk away, and actually result in lower target returns for contracts with target-protective terms, because in those deals targets have bought greater deal certainty by giving up value.

\*\*\*Table 8\*\*\*

## **VI. Conclusions**

In this paper, we examine the value-relevance of M&A contracts, which are typically chosen together in a package of negotiated terms. We build M&A contract clause indices based on legal scholars’ and practitioners’ *a priori* predictions, in the spirit of the Entrenchment Index of Bebchuk, Cohen, and Ferrell, (2009). We find that all three indices exhibit wide variations and low correlation with each other, which allows us to examine their differential impact on abnormal returns earned by bidder and target shareholders in a large sample of M&A deals. First, we find provide evidence that buyer protective index, built primarily on RTFs, termination duration, and MAC clauses, is positively related to bidder announcement CARs. Second, we find that a higher target protective index, built primarily on termination duration, walkaway clauses and MAC exclusions, results in higher target announcement CARs. Finally, we show that pro-competition index, which is built on TTFs, match rights and go-shop clauses, is positively related to target announcement CARs.

Our results for M&A contract clauses are not consistent with the “churning” hypothesis, in which merger agreements consist of standardized terms with no economically consequential market impacts (see Manns and Anderson (2012), and Manns and Anderson (2016)). On the contrary, we find evidence that many clauses in heavily negotiated M&A contracts are value relevant to bidders and target shareholders. We find that the bidder and target protective indices have larger value impact in “bad” deals than for “good” deals, consistent with contracts mattering more where bidders are closer to indifferent in their intrinsic motivation to complete the transaction. Given substantial growth in the length of M&A contracts over time, our findings are consistent with the argument that M&A contract clauses have significant value-relevance because they are drafted by expert lawyers with at least directionally correct incentives to modify and innovate on prior contracts to fit each individual deal (see Cain, Macias, and Davidoff Solomon (2014), and Coates (2016)).

While our research design does not allow us to make strong claims about causality, we do find that M&A contract clauses indices correlate consistently and strongly with stock price reactions while controlling for other factors that influence market reactions. Our empirical design and evidence suggest that future research on abnormal returns earned by bidders and targets should include these M&A contract indices.

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**Table 1: Variable Definitions**

Panel A: M&A contract clauses Variables	
Variable	Definition
<i>eff_rtf</i>	Dummy variable equal to unity when the reverse termination fee clause is efficient based on its triggering events. Inefficient RTF is defined as a bidder termination provision with a fiduciary out trigger is included in a cash deal or a deal where the acquirer's firm size is much larger relative to the target's firm size.
<i>long_term_dur</i>	Dummy variable equal to unity if termination duration is higher than the median, and zero otherwise.
<i>financingcondition</i>	Dummy variable equal to unity if the agreement includes a buyer financing condition section, and zero otherwise.
<i>buyerapproval</i>	Dummy variable equal to unity if the tender offer is used and the agreement includes a buyer shareholder approval condition section, and zero otherwise.
<i>MEPerc</i> <sup>8</sup>	Quasi-percentage of total MAC/MAE provisions to total of all provisions = $\text{totmac} / (\text{totmac} + \text{totexc} + 1)$ , where $\text{totexc}$ = total number of MAC/MAE Exclusions.
<i>competitivebidout</i>	Dummy variable equal to unity when a target termination fee exists and the termination fee clause is triggered by an alternative bid, and zero otherwise.
<i>matchrightspresence</i>	Dummy variable equal to unity if the agreement includes a right for the acquirer firms to respond to topping bids, and zero otherwise.
<i>goshoppresence</i>	Dummy variable equal to unity if the agreement includes a right for target to solicit topping bids for X days after signing, and zero otherwise.
<i>walkawaypresence</i>	Dummy variable equal to unity if the agreement provide targets the ability to walk away if the buyer's stock price falls by X%, absolutely or relative to an index, and zero otherwise.
Panel B: M&A contract clauses Indices	
Variable	Definition
<i>buyer_protective_index</i>	For all deals, $\text{buyer\_protective\_index} = \text{eff\_rtf} + \text{financingcondition} + \text{buyerapproval} + \text{MEPerc}$ ; For "good" deals, $\text{buyer\_protective\_index} = \text{eff\_rtf} + \text{financingcondition} + \text{buyerapproval} + \text{MEPerc} + \text{long\_term\_dur}$ ; For "bad" deals, $\text{buyer\_protective\_index} = \text{eff\_rtf} + \text{financingcondition} + \text{buyerapproval} + \text{MEPerc} + (1 - \text{long\_term\_dur})$ .
<i>target_protective_index</i>	For all deals, $\text{target\_protective\_index} = (1 - \text{long\_term\_dur}) + \text{walkawaypresence} + (1 - \text{MEPerc})$ ; For "good" deals, $\text{target\_protective\_index} = (1 - \text{MEPerc})$ ; For "bad" deals, $\text{target\_protective\_index} = (1 - \text{long\_term\_dur}) + \text{walkawaypresence} + (1 - \text{MEPerc})$ .
<i>competition_index</i>	For all deals, $\text{competition\_index} = \text{competitivebidout} + \text{matchrightspresence} + \text{goshoppresence}$ .

<sup>8</sup> Use the MAC Score variable in Table 3 of Talley (2009).

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Panel C: Control Variables

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Variable	Definition
<i>toehold_fraction</i>	A continuous measure of the fraction of target shares held by the bidder prior to announcement (toehold shares).
<i>related</i>	Dummy variable equal to unity if the bidder is from the same industry as the target (where industry definitions are taken from Fama and French) and zero otherwise
<i>lnrelsize</i>	The natural logarithm of target's market value less natural logarithm of acquirer's market value.
<i>tender</i>	Dummy variable equal to unity if the bid is structured as a tender offer, and zero otherwise.
<i>cashpct</i>	The percentage of cash that is used in the merger.
<i>mkttobk_tgt</i>	The target firm's market-to-book ratio in the fiscal year prior to the merger.
<i>mkttobk_acq</i>	The acquiring firm's market-to-book ratio in the fiscal year prior to the merger.
<i>lev_tgt</i>	The target firm's total debt divided by its total assets in the year prior to the merger.
<i>lev_acq</i>	The acquiring firm's total debt divided by its total assets in the year prior to the merger.
<i>fcf_tgt</i>	The target firm's free cash flow in the year prior to the merger.
<i>fcf_acq</i>	The acquiring firm's free cash flow in the year prior to the merger.
<i>tgt_insiderown</i>	The fractional ownership of the target firm's officers and directors in the year prior to the merger.
<i>acq_insiderown</i>	The fractional ownership of the acquiring firm's officers and directors in the year prior to the merger.

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**Table 2: Sample Creation Methodology**

Sample Creation	# of observations
U.S. domestic mergers from SDC (2001-2011)	109,098
Dropped if no stock return data from CRSP	(100,610)
Initial Sample	8,488
Dropped if acquirer name equal to target name in SDC (e.g. parent-subsiary mergers)	(6,681)
Dropped if the form is not “merger” in SDC (e.g. equity carve outs)	(281)
Dropped if form 8K is not filed with the SEC	(280)
Dropped if no merger agreement in form 8K	(351)
Dropped if any independent variables in regression are missing	(76)
Final Sample	819

### Table 3: Descriptive Statistics

This table reports descriptive statistics for M&A contract clauses indices and individual M&A contract clauses. All variables are defined in Table 1.

Panel A: Descriptive statistics for value-relevant M&A contract clauses indices			
Variable	Mean	Median	Standard Deviation
<i>buyer_protective_index</i>	0.61	0.36	0.53
<i>competition_index</i>	1.85	2.00	0.43
<i>target_protective_index</i>	1.34	1.57	0.57

  

Panel B: Correlations between indices			
	<i>buyer_protective_index</i>	<i>competition_index</i>	<i>target_protective_index</i>
<i>buyer_protective_index</i>	1.0000		
<i>competition_index</i>	-0.0004	1.0000	
<i>target_protective_index</i>	-0.0519	-0.0320	1.0000

  

Panel C: Descriptive statistics for individual M&A contract clauses			
Variable	Mean	Median	Standard Deviation
<i>eff_rtf</i>	0.19	0	0.39
<i>financingcondition</i>	0.09	0	0.29
<i>buyerapproval</i>	0.01	0	0.09
<i>MEPerc</i>	0.32	0.29	0.15
<i>competitivebidout</i>	0.97	1	0.17
<i>matchrightspresence</i>	0.86	1	0.35
<i>goshoppresence</i>	0.01	0	0.12
<i>long_term_dur</i>	0.50	1	0.50
<i>walkawaypresence</i>	0.16	0	0.37

**Table 4: Bidder and Target Announcement Abnormal Returns**

This table contains means and medians for bidder announcement abnormal returns in 819 public deals from 2001 to 2011. Panel A and C report bidder and target daily abnormal returns. Panel B and D report bidder and target cumulative abnormal returns over two periods, i.e. event day -1 to event day +1, event day -3 to event day +3, where event day 0 is the merger agreement filing date. The abnormal returns are measured relative to a market model estimated for the bidder over a 240-day period ending 60 days prior to bid announcement. \*\*\*, \*\*, \* indicates statistical significance at the 1%, 5%, or 10% level, respectively.

Panel A: Bidder Daily Abnormal Returns		
Date	Mean	Median
-3	-0.01%	-0.08%
-2	-0.01%	-0.12%
-1	-0.50%***	-0.25%***
0	-0.95%***	-0.46%***
+1	0.15%	-0.07%
+2	-0.08%	-0.06%
+3	-0.03%	-0.11%
Panel B: Bidder Cumulative Abnormal Returns [CAR]		
CAR[periods]	Mean	Median
CAR[-1,+1]	-1.31%***	-0.71%***
CAR[-3,+3]	-1.45%***	-1.33%***
Panel C: Target Daily Abnormal Returns		
Date	Mean	Median
-3	2.81%***	0.39%***
-2	2.28%***	0.12%***
-1	6.11%***	0.56%***
0	12.11%***	1.68%***
+1	0.67%***	-0.06%
+2	-0.14%	-0.11%
+3	-0.05%	-0.17%***
Panel D: Target Cumulative Abnormal Returns [CAR]		
CAR[periods]	Mean	Median
CAR[-1,+1]	18.90%***	12.71%***
CAR[-3,+3]	23.79%***	18.90%***

**Table 5: CARs and Value-Relevant M&A contract clauses Indices**

This table reports the OLS regression results for a sample of 819 public deals from 2001 to 2011. The dependent variable is bidder cumulative abnormal returns over event day - 1 to event day +1, where event day 0 is the merger agreement filing date. All independent variables are defined in previous tables. Year dummies are included but their coefficients are not reported. *t*-statistics are computed based on robust standard errors that incorporate firm-level clustering and are reported in parentheses. \*\*\*, \*\*, \* indicate that the parameter estimate is significantly different from zero at the 1%, 5%, or 10% level, respectively.

	Bidder CAR [-1, +1]		Target CAR [-1, +1]	
	(1)	(2)	(3)	(4)
<i>buyer_protective_index</i>	0.0191*** (3.01)	0.0211*** (3.02)	-0.0090 (-0.52)	0.0028 (0.15)
<i>competition_index</i>	0.0033 (0.40)	0.0130 (1.01)	0.0462** (2.58)	0.0682*** (2.63)
<i>target_protective_index</i>	-0.0078 (-1.61)	-0.0095* (-1.72)	0.0253 (1.65)	0.0329* (1.80)
<i>toehold</i>	0.0035 (0.22)	0.0209 (1.09)	-0.0790* (-1.74)	-0.0666 (-1.34)
<i>related</i>	-0.0023 (-0.41)	0.0018 (0.31)	-0.0022 (-0.10)	0.0097 (0.40)
<i>relsize</i>	-0.0002*** (-3.73)	-0.0001** (-2.14)	-0.0009*** (-4.03)	-0.0009*** (-3.70)
<i>tender</i>	0.0047 (0.76)	0.0124* (1.79)	0.0767* (1.90)	0.0947** (2.05)
<i>cashpct</i>	0.0003*** (4.00)	0.0003*** (3.63)	0.0009*** (3.51)	0.0009*** (2.93)
<i>mkttobk_tgt</i>		-0.0023 (-1.26)		-0.0197*** (-3.07)
<i>lev_tgt</i>		0.0032 (0.18)		-0.0400 (-0.70)
<i>fcf_tgt</i>		-0.0000*** (-10.32)		-0.0000* (-1.67)
<i>tgt_insiderown</i>		0.0395 (1.42)		-0.1129 (-0.91)
<i>mkttobk_acq</i>		-0.0028 (-1.26)		0.0158** (2.03)
<i>lev_acq</i>		0.0130 (0.62)		0.0766 (0.98)
<i>fcf_acq</i>		-0.0000 (-0.12)		0.0000* (1.73)
<i>acq_insiderown</i>		-0.0420 (-0.51)		0.0166 (0.12)
<i>n</i>	818	680	818	680
<i>Adjusted R<sup>2</sup></i>	0.044	0.078	0.084	0.099

**Table 6: CARs and Value-Relevant M&A contract clauses Indices with Alternative Event Window**

This table reports the OLS regression results for a sample of 819 public deals from 2001 to 2011. The dependent variables are bidder and target cumulative abnormal returns over event day - 3 to event day +3, where event day 0 is the merger agreement filing date. All independent variables are defined in previous tables. Year dummies are included but their coefficients are not reported. *t*-statistics are computed based on robust standard errors that incorporate firm-level clustering and are reported in parentheses. \*\*\*, \*\*, \* indicate that the parameter estimate is significantly different from zero at the 1%, 5%, or 10% level, respectively.

	Bidder CAR [-3, +3]		Target CAR [-3, +3]	
	(1)	(2)	(3)	(4)
<i>buyer_protective_index</i>	0.0290*** (2.79)	0.0222** (2.58)	-0.0253 (-1.32)	-0.0223 (-1.06)
<i>competition_index</i>	-0.0034 (-0.26)	0.0199 (1.18)	0.0624** (2.54)	0.1098*** (3.13)
<i>target_protective_index</i>	-0.0088 (-1.39)	-0.0071 (-1.02)	0.0302* (1.74)	0.0401* (1.95)
<i>toehold</i>	-0.0310 (-1.42)	0.0013 (0.05)	-0.1367** (-2.40)	-0.0814 (-1.51)
<i>related</i>	0.0065 (0.87)	0.0087 (1.16)	0.0046 (0.19)	0.0201 (0.78)
<i>resize</i>	-0.0001 (-0.53)	-0.0001 (-1.37)	-0.0010*** (-3.08)	-0.0008*** (-2.99)
<i>tender</i>	0.0058 (0.69)	0.0159* (1.75)	0.0945** (2.24)	0.1104** (2.42)
<i>cashpct</i>	0.0003*** (4.11)	0.0004*** (3.91)	0.0010*** (3.82)	0.0009*** (2.86)
<i>mkttobk_tgt</i>		-0.0018 (-0.67)		-0.0174** (-2.19)
<i>lev_tgt</i>		0.0005 (0.02)		-0.0752 (-1.15)
<i>fcf_tgt</i>		-0.0000*** (-7.01)		-0.0000*** (-5.62)
<i>tgt_insiderown</i>		0.0766** (2.28)		-0.0140 (-0.10)
<i>mkttobk_acq</i>		-0.0065** (-2.26)		0.0109 (1.34)
<i>lev_acq</i>		0.0125 (0.47)		0.0646 (0.66)
<i>fcf_acq</i>		0.0000 (0.58)		0.0000 (1.27)
<i>acq_insiderown</i>		-0.0483 (-0.40)		-0.0998 (-0.78)
<i>n</i>	818	680	818	680
<i>Adjusted R<sup>2</sup></i>	0.035	0.062	0.090	0.100

**Table 7: Deal Completion Rates and Value-Relevant M&A contract clauses Indices**

This table reports the Probit regression results for a sample of 819 public deals from 2001 to 2011. The dependent variable is the dummy variable for deal completion and it equals to unity when the deal is completed, and zero otherwise. All independent variables are defined in Table 1. Year dummies and industry dummies are included but their coefficients are not reported. *t*-statistics are computed based on robust standard errors that incorporate firm-level clustering and are reported in parentheses. \*\*\*, \*\*, \* indicate that the parameter estimate is significantly different from zero at the 1%, 5%, or 10% level, respectively.

	(1)	(2)	(3)	(4)
<i>buyer_protective_index</i>	-0.2868*** (-2.59)			-0.2866** (-2.56)
<i>competition_index</i>		0.0982 (0.58)		0.1013 (0.60)
<i>target_protective_index</i>			0.0305 (0.23)	0.0206 (0.16)
<i>toehold</i>	0.2556 (0.57)	0.1827 (0.40)	0.1975 (0.43)	0.2653 (0.60)
<i>ln_mve_tgt</i>	0.0146 (0.32)	0.0153 (0.35)	0.0207 (0.45)	0.0150 (0.32)
<i>tender</i>	-0.2278 (-1.00)	-0.2383 (-1.04)	-0.2323 (-1.01)	-0.2361 (-1.03)
<i>cashpct</i>	0.0073*** (3.75)	0.0076*** (3.90)	0.0076*** (3.88)	0.0073*** (3.79)
<i>tgt_reg_ind</i>	0.0578 (0.35)	0.0922 (0.54)	0.0725 (0.45)	0.0836 (0.49)
<i>tgt_tech_ind</i>	-0.2520 (-1.29)	-0.2384 (-1.23)	-0.2259 (-1.18)	-0.2564 (-1.33)
<i>t_vol</i>	19.7586 (0.67)	12.1472 (0.42)	12.9604 (0.45)	18.7770 (0.64)
<i>n</i>	818	817	818	817
<i>Pseudo R<sup>2</sup></i>	0.081	0.069	0.068	0.081



**Table 8: CARs and Value-Relevant M&A contract clauses Indices in Stock Financed Deals and in All Cash Financed Deals**

Panel A reports the OLS regression results for a sample of 532 stock financed public deals from 2001 to 2011. The dependent variable is bidder cumulative abnormal returns over event day  $-1$  to event day  $+1$ , where event day 0 is the merger agreement filing date. All independent variables are defined in previous tables. All independent variables and year dummies are included but their coefficients are not reported.  $t$ -statistics are computed based on robust standard errors that incorporate firm-level clustering and are reported in parentheses. \*\*\*, \*\*, \* indicate that the parameter estimate is significantly different from zero at the 1%, 5%, or 10% level, respectively. Panel B reports the OLS regression results for a sample of 287 all cash financed public deals from 2001 to 2011. The dependent variable is bidder cumulative abnormal returns over event day  $-1$  to event day  $+1$ , where event day 0 is the merger agreement filing date. All independent variables are defined in previous tables. All independent variables and year dummies are included but their coefficients are not reported.  $t$ -statistics are computed based on robust standard errors that incorporate firm-level clustering and are reported in parentheses. \*\*\*, \*\*, \* indicate that the parameter estimate is significantly different from zero at the 1%, 5%, or 10% level, respectively. Panel C reports the differences of regression coefficients on M&A contract clauses indices between stock financed deals and all cash financed deals. \*\*\*, \*\*, \* indicate that the parameter estimate is significantly different from zero at the 1%, 5%, or 10% level, respectively.

Panel A: Stock Financed Deals (i.e. 532 deals)				
	Bidder CAR [-1, +1]	Bidder CAR [-3, +3]	Target CAR [-1, +1]	Target CAR [-3, +3]
	(1)	(2)	(3)	(4)
<i>buyer_protective_index</i>	0.0188** (2.20)	0.0204** (1.99)	0.0125 (0.59)	-0.0005 (-0.02)
<i>competition_index</i>	0.0072 (0.48)	0.0150 (0.76)	0.0575** (2.04)	0.0977** (2.49)
<i>target_protective_index</i>	-0.0215** (-2.53)	-0.0207* (-1.95)	0.0274 (1.27)	0.0535** (2.11)
Panel B: All Cash Financed Deals (i.e. 287 deals)				
	Bidder CAR [-1, +1]	Bidder CAR [-3, +3]	Target CAR [-1, +1]	Target CAR [-3, +3]
	(1)	(2)	(3)	(4)
<i>buyer_protective_index</i>	0.0068 (1.23)	0.0040 (0.54)	-0.0280 (-0.99)	-0.0354 (-1.34)
<i>competition_index</i>	0.0178 (1.06)	0.0352 (1.39)	0.1110* (1.91)	0.1643*** (2.61)
<i>target_protective_index</i>	0.0113 (0.38)	-0.0098 (-0.27)	-0.3030* (-1.78)	-0.3622** (-2.33)
Panel C: Difference between Stock Financed Deals and All Cash Financed Deals				
	Bidder CAR [-1, +1]	Bidder CAR [-3, +3]	Target CAR [-1, +1]	Target CAR [-3, +3]
	(1)	(2)	(3)	(4)
<i>buyer_protective_index</i>	0.0120**	0.0164*	0.0405	0.0349
<i>competition_index</i>	-0.0106	-0.0202	-0.0535	-0.0666
<i>target_protective_index</i>	-0.0328	-0.0109	0.3304	0.4157*