CONSTRUCTION CLAUSES IN MERGER AGREEMENTS

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Abstract

This paper examines whether (and when) parties to merger and acquisition deals include include "construction" clauses in their contract. These clauses recite that both parties are represented by counsel, have participated in drafting the agreement and waive legal doctrines that construe ambiguity against the drafter. Using a large sample over an 11-year period, we find that construction clauses are quite common in public company merger agreements with 23.6% (196 out of 831) of deals including these terms. We also find a higher likelihood of having a construction clause in the merger agreement when the state chosen by the choice of forum and law clause has rules of interpretation that favor the use of contextual evidence in addition to the written agreement in resolving disputes, or when the choice of forum and law is Delaware, or when the target is a high-risk firm. Controlling for the endogenous choice of including a construction clause in the agreement, we find no evidence that inclusion changes the value of the combined firm on merger announcement. Finally, we find no statistically significant impact of deal lawyer reputation or familiarity on the likelihood of the merger agreement having a construction clause, or of New York as the choice of forum, or of an economically powerful bidder acquiring a smaller target, or of international or high-risk acquirers, or whether the deal was completed.

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1. INTRODUCTION

Contract theory postulates that contracts are written to achieve the twin objectives of efficient ex ante investment in the subject matter of the contract and efficient ex post trade. Parties trade efficiently when the value of the performance to the buyer exceeds the cost of performance to the seller, and they rely or invest efficiently when their reliance on the contract maximizes the expected surplus net of contracting costs (Schwartz & Scott (2003)). In order to maximize the contractual surplus, theory holds that contracts are drafted so as to shift contracting costs between the front end of the transaction (the negotiation and drafting stage) and the back end of the transaction (the enforcement and litigation stage) (Scott & Triantis (2006); Choi & Triantis (2008)).

In this paper, we examine whether parties to merger and acquisition transactions expend front end costs to negotiate and draft a clause in the merger agreement called the clause of construction (or "construction" clause) in response to the anticipated back end costs of enforcement.[1] Constructions clauses are stipulations that both parties have been represented by counsel during the negotiation and drafting of the merger agreement, and that they waive the application of any law or rule of construction providing that ambiguities in the agreement will be construed against the party drafting such agreement. Construction clauses are thus designed to negate the possible application of the contractual doctrine of *contra proferentem* (Latin for 'against the offeror') under which the preferred meaning of an ambiguous term in a contract should be the one that works against the interests of the party providing the wording (Gilson, Sabel & Scott 2014).

We focus on mergers between companies in order to analyze a generally homogenous contracting environment. Merger contracts are highly negotiated, involve sophisticated parties, deal with large and material amounts, and are very enforceable.

[1] For an excellent explanation of merger and acquisition contract characteristics see John C. Coates IV., M&A Contracts: Purposes, Types, Regulations, and Patterns of Practice, working paper, Harvard L. School, (2015).

Litigation is likely to be standardized about deal price, and consist of derivative suits involving whether the deal price was too high or too low and whether the acquirer did not 'close on the deal.'

While not analyzing construction clauses per se, a number of papers have examined the incidence of various contract terms in merger and acquisition agreements. Coates (2012) finds that dispute management provisions such as arbitration clauses, choice of law and forum clauses, legal cost allocation clauses, and clauses that award specific performance in the event of a breach are related to firm and deal characteristics, and in some cases vary with the M&A experience of lawyers. Similarly, other studies have examined material adverse change clauses (Gilson & Schwartz (2005)), (Miller (2007)), Denis & Macias (2013)), and jury waiver clauses (Eisenberg & Miller (2006)), (Palia & Scott (2015)).

This paper examines a large sample of 831 publicly traded deals [2] over an 11-year period (2001 to 2011) to assess various hypotheses that potentially impact the probability of merger agreements having a construction clause,[3] and the impact of such clauses on the value of the merger. We find the following results. First, we find that construction clauses are fairly common in merger agreements with 23.6% (196 out of 831) of deals having such a clause. Second, we find there is a higher likelihood of parties including a construction clause in the merger agreement when the choice of forum and law designate one of the ten states whose contract law rules of interpretation favor the introduction of extrinsic or contextual evidence in addition to the written agreement.[4] This result suggests that

[2] Publicly traded deals are those wherein both the acquirer and target firm are traded in U.S. capital markets.

[3] See Section 2 of this paper for detailed explanation of the various hypotheses that potentially correlate with the likelihood of a construction clause being included in the merger agreement.

[4] The states that have "soft" rules of interpretation are Alabama, Alaska, Arizona, California, Michigan, New Jersey, New Mexico, Texas, Vermont and Washington. See Robert E. Scott, State by State Survey (Oct, 7, 2009) (on file with authors). A strong majority of U.S. courts diverge from those states and follow a traditional "formalist approach to contract interpretation in which, where the written contract is clear, the

lawyers for deal parties are more likely to negotiate for an explicit construction clause when subsequent disputes will be adjudicated under expansive rules of contract interpretation that invite the application of canons of construction such as *contra proferentem*.

Third, we find that merger agreements that designate the Delaware Chancery Court, noted for its expertise in resolving corporate contests (Gilson, Sabel & Scott (2014)), as the choice of forum and law have a higher likelihood to include an explicit construction clause. No such effect is found for deals whose choice of forum and law is New York, the largest commercial state whose formalist rules of interpretation are widely popular with business parties (Miller 2010, Gilson, Sabel & Scott 2014)). Fourth, we find a higher probability that a merger agreement will contain a construction clause when the target is a "high-risk" firm. No such statistically significant effect is found when the acquirer is a high-risk firm. Fifth, we find no statistically significant impact on the likelihood of having a construction clause of the professional reputation of the deal lawyers or their familiarity with each other, or whether the acquirers are an international firm, or when an economically powerful acquirer takes over a smaller target, or whether the deal was completed. Finally, controlling for the endogenous choice of including a construction clause in the merger agreement, we find no evidence that construction clauses increase or decrease the value of the combined firm on announcement of the merger.

There are two important caveats to this paper. First, all our results are based on correlations between quantifiable variables using Probit regression analysis and are not subject to any causal claim. In order to make causal arguments, we need to identify an exogenous shock that was not expected by the various participants in the merger and acquisitions market place. Second, it is clear that there are many other contract terms that are jointly determined along with construction clauses. In order to find an independent effect of each contract clause one needs to identify accurately a simultaneous system of

parties are disabled from inquiring into the context surrounding the contract. (Schwartz & Scott 2010 and Gilson, Sabel & Scott 2014)

equations. It is extremely hard, and one might also say close to impossible, to identify natural exogenous variables (also called instrumental variables in the econometric literature) which effect one choice variable (such as construction clauses) and not another choice variable (such as choice of law and forum). That said, our empirical approach is consistent with other studies that examine mergers and acquisitions using regression analysis.

This paper proceeds as follows. Section 2 explains our hypotheses for the determinants of construction clauses. Section 3 describes our data, definitions and sources for variables. Our empirical results are reported in Section 4, and conclusions presented in Section 5.

2. HYPOTHESES FOR DETERMINANTS OF CONSTRUCTION CLAUSES

In this section we construct hypotheses that correlate with the ex ante probability of a merger deal having a construction clause.

2.1 Contextual versus Textual Interpretation States.

Merging firms must choose a state for dispute resolution which is often called choice of governing forum and law.[5,6] Legal scholars have long debated whether contract law should follow a formalist or contextualist interpretive style. The issue has its roots in the disagreement between two giants of contract scholarship; Samuel Williston who favored the formalist, or textualist, approach, and Arthur Corbin who favored the more

[5] We do not include the merging firms' state of incorporation because a large majority of acquirers are from Delaware or New York, or more recently Nevada, and firms choose their state of incorporation many years before a merger. Additionally, there is conflicting evidence about the value effects of incorporating in Delaware. Under the "race-to-the-top" view, Delaware has been the dominant state of incorporation because its law maximizes firm value (see Winter (1977)), Romano, (1985)); Daines, (2001)). Alternatively, under the "race-to-the-bottom" view, Delaware has prevailed by offering corporate law that favors managerial interests at the expense of other parties' such as shareholders and consumers (See Cary, (1974)); Bebchuk, (1992)). Finally, some authors (See Bebchuk & Alan Ferrell (2001); Bebchuk, Cohen & Ferrell, (2002)); Subramanian (2004); Litvak (2011)) have suggested that different firms choose their state of incorporation endogenously and firms are in equilibrium; Barzuza (2012) and Barzuza & Smith (2014), suggest that many firms have recently selected Nevada as the state of incorporation in order for their managers to extract private benefits of control.

[6] The typical merger agreement contains both choice of forum and choice of law provisions, most often combined in a single contract term. See e.g. Agreement and Plan of Merger and Reorganization among Chordiant Software, Inc., Puccini Acquisition Corp., and Prime Response, Inc., January 8, 2001.

> 9.5 Applicable Law: Jurisdiction. This agreement shall be governed by, and construed in accordance with, the laws of the State of Delaware, regardless of the laws that might otherwise govern under applicable principles of conflicts of laws thereof. In any action between any of the parties arising out of or relating to the Agreement: (a) each of the parties irrevocably and unconditionally consents and submits to the exclusive jurisdiction and venue of the state and federal courts located in the state of Delaware…

A random search in our sample of merger agreements yielded only five agreements where the choice of forum and choice of law terms appeared as separate terms of the contract. In each of the five cases, the agreements identified the same state as the forum state and the source of governing law.

contextualist approach. More recently, Schwartz and Scott (2010) have argued that the formalist approach is the more efficient default for resolving interpretive disputes between business firms, as it balances the benefits of interpretative accuracy with the costs of adjudication.

Ten states[7] reject the textualist interpretation of business contracts: they apply a soft version of the parol evidence rule and invite courts to consider a variety of extrinsic or contextual evidence when interpreting disputed contracts (Schwartz & Scott (2010), Gilson, Sabel and Scott (2014)). This interpretive approach raises the threshold for summary judgment relative to the remaining textualist jurisdictions. Given that the expected costs of litigation are likely to be higher when the choice of law and forum is one of these ten states,[8] parties to merger agreements are motivated to negotiate an explicit construction clause in order to limit access by a disappointed party to sources extrinsic to the merger agreement in a subsequent litigation.

Hypothesis: Construction clauses are more likely when the state of law and forum is one of the ten states that have adopted a contextualist interpretation of commercial contracts.

2.2 Delaware and New York as Dominating Choice of Forum and Law States

Many legal scholars have found that Delaware and New York dominate the choice of firms selecting by contract their preferred state of governing law and litigation forum. For example, Eisenberg and Miller (2006) examine 412 merger agreements in the first seven months of 2002 and find that Delaware accounts for 32% of the governing law cases followed

[7] See note 4 infra.

[8] Litigation costs are a function of parties' ability to resolve disputes at summary judgment and thus avid the punishing costs of a full trial on the merits. Summary judgment will be denied, however, if the court determines that it must examine evidence extrinsic to the written agreement in order to resolve the dispute. (Scott & Kraus (2013)).

by New York at 17%. Cain and Davidoff (2012) examine a large sample of merger agreements from 2004-2008 and find that Delaware accounts for over 60% of the governing law and forum cases followed by New York accounting for around 12%. Cain and Davidoff find that the attractiveness of Delaware has increased over time and so has its success relative to New York. Alternatively, some studies[9] have found that there is a flight from Delaware to New York for firms whose state of incorporation is neither New York nor Delaware.

The rules of interpretation in both New York and Delaware conform to the traditional common law, textualist style of interpretation[10] This interpretive approach privileges integrated contracts over context evidence that arguably suggests the agreement contained additional or different terms or meanings. Textualist jurisdictions, such as Delaware and New York, use a "hard" parol evidence rule that gives presumptively conclusive effect to merger or integration clauses, and, in their absence, presumes that the contract is fully integrated if it appears final and complete on its face.[11] Thus, both states have generally more predictable adjudication environments. The relative value of a construction clause is

[9] See Eisenberg & Miller (2009); Armour, Black, & Cheffins (2012) and Sanga, (2014) (finding that firms choose their state of forum to be Delaware and Nevada when their state of incorporation is not these two states because they are "locked-in" to learning the laws of one or two jurisdictions, whereas firms choose their state of forum to be New York when their state of incorporation is not New York, because of the "network effects" of other firms and lawyers using New York as their choice of forum).

[10] See note 4 infra.

[11] For New York, *see, e.g.*, Morgan Stanley High Yield Sec., Inc. v. Seven Circle Gaming Corp., 269 F. Supp. 2d 206 (S.D.N.Y. 2003) (holding that the prior agreement is excluded where the writing appears in view of thoroughness and specificity to embody a final agreement); Intershoe, Inc. v. Bankers Trust Co., 571 N.E.2d 641, 644 (N.Y. 1991) (same); Mitchill v. Lath, 160 N.E. 646, 646-48 (N.Y. 1928) (upholding the "four corners "presumption and excluding evidence of collateral agreement to land sale contract). In addition, merger clauses are given virtually conclusive effect in New York. *See* Tempo Shain Corp. v. Bertek, Inc., 120 F.3d 16, 21 (2d Cir. 1997) ("Ordinarily, a merger clause provision indicates that the subject agreement is completely integrated, and parol evidence is precluded from altering or interpreting the agreement."); Norman Bobrow & Co. v. Loft Realty Co., 577 N.Y.S.2d 36, 36 (App. Div. 1991) ("Parol evidence is not admissible to vary the terms of a written contract containing a merger clause."). For Delaware, see e.g., Pellaton v. Bank of New York, 592 A.2d 473 (Del. 1991) (if the instrument is clear and unambiguous on its face, neither this Court nor the trial court may consider parol evidence "to interpret it or search for the parties' intent [ions]….") (quoting Hibbert v. Hollywood Park, Inc., Del.Supr., 457 A.2d 339, 343 (1983) City Investing co. v. Continental Cas. Co., 624 A.2d 1191,1198 (Del. Supr. 1993); Rainbow Navigation, Inc. v. Yonge, Del. Ch. ,C.A. No.9432, Allen, C. (Apr. 24 (1989) (the clear meaning rule is the "first principle of interpretation);

diminished in states with textualist interpretive theories as courts are less inclined to find contract terms ambiguous and thus less likely to invoke principles such as *contra proferemtem*.

There is, however, a significant difference between Delaware and New York in the reputation for expertise in resolving M&A contests that is enjoyed by the Delaware Chancery Court. The Chancery Court handles a large number of highly complex transactions that share general features, but where each transaction has significant idiosyncrasies, and the common background conditions shift rapidly. Intimate familiarity with the evolving commercial practice may permit an expert court, such as the Delaware Court of Chancery, to reliably recover the contextual facts needed to resolve corporate acquisition disputes (Gilson, Sabel & Scott (2014)). On the other hand, generalist courts, including the courts in New York are denied access to such specialized knowledge. In this respect the Delaware Chancery Court resembles the early English courts of equity: it has deep knowledge of the community whose disputes it resolves, as did the early courts of equity with respect to the homogenous economy in which its litigants operated. The fact that the Delaware Chancery Court is prepared to evaluate contextual evidence in merger agreement disputes even though its common law interpretive rules are textualist increases the benefits of negotiating a construction clause in the merger agreement relative to New York whose courts continue to adhere strictly to textualist modes of interpretation.

Hypothesis: Construction clauses are more likely to be negotiated when the state of forum and law is Delaware rather than New York.

2.3 Bargaining Power

The capacity of a party to insist on a given contract term in the merger agreement is often influenced by that parties' relative bargaining power. Bargaining power is a function of many factors but at least one is the relative economic power of the parties to

the agreement.[12] Moreover, this disparity in bargaining power is precisely the circumstance in which a court might be persuaded to apply a *contra proferentem* interpretation against the interest of the more powerful party. For example, if a large and economically powerful acquirer takes over a smaller target firm, the acquirer might wish to include a construction clause in the contract to overcome the *contra proferentem* axiom that works against the acquiring firm as the perceived drafter of the merger agreement.

Hypothesis: Construction waiver clauses are more likely if the acquirer is much more economically powerful than the target firm.

2.4 Firm risk

Firms often use mergers to diversify or increase their risk. Accordingly, an acquirer might insist on a construction clause to lower the risks from the spill-over effects of future litigation when taking over a high risk target firm. Similarly, a low-risk acquirer might exclude the construction clause because it does not anticipate a high probability of spill-over consequences from future litigation when taking over a target firm.

Hypothesis: Construction clauses will be more likely when the merger involves a high-risk acquiring firm.

Hypothesis: Construction clauses will be more likely when the merger involves a high-risk target firm.

[12] In standard bargaining theory, bargaining power is a function of two factors—patience and each party's next best option. A business party's patience is a function of its ability to finance its projects. Thus, firms that are economically powerful in that they have capital or convenient access to capital can be more patient than firms that need revenue immediately to survive. (Schwartz & Scott (2003)).

2.5 Law Firm reputation

Attorneys associated in a law firm with a strong reputation for legal skill and experience are likely to be more confident in their ability to negotiate merger deals that are favorable to their clients' interests.[13] On the one hand, skilled and experienced attorneys are more likely to be familiar with the jurisdictional divide between textualist and contextualist styles of contract interpretation and, as a consequence, are likely to be cognizant of the expected efficiency gains from choosing to litigate in a textualist state.

Hypothesis: Construction clauses will be more likely when the lawyers involved have a reputation for providing highly skilled legal services.

On the other hand, skilled and experienced attorneys with excellent reputations might want to retain the option of invoking *contra proferentem* in order to deploy their legal skills ex post to persuade the court to adopt an interpretation of the contract that favors their clients. In such a case, transactional attorneys who are in partnership with highly skilled litigation specialists might be confident of their colleagues' superior ability relative to opposing counsel to persuade the court to adopt their client's interpretation of the contract. But this argument seems factually implausible since construction clauses are designed by the merger transaction lawyer and not by the litigation specialist (who is

[13] A number of papers have shown that law firm reputation is important. In a finitely repeated prisoner's dilemma game, Gilson & Mnookin (1994) suggest that clients can use lawyers with strong reputation to credibly signal to the other side that they are cooperative; in an experimental setting, Croson & Mnookin (1997) find supporting evidence that principals will choose agents that sustain more cooperation than on their own; Gilson (1984) suggests that business lawyers create value by being transaction cost engineers that increase the market value of their clients' transactions; Okamoto (1995) suggests that law firm reputation is a credible bond or commitment device in the form of a legal opinion being made on behalf of the client firm; Krishnan & Masulis, (2013) find that top law firms increase the takeover premium for their client firms, top bidder law firms have higher completion rates and top target law firms have higher withdrawal rates; Coates IV (2012),finds that law firms with more M & A experience but less private target firm experience are less likely to choose Delaware as the forum for dispute resolution, whereas firm with less merger and acquisition experience omit forum selection clauses; and Krishnan, Masulis, Thomas, & Thompson (2013) find that top law firms representing both bidders and targets increase the probability of shareholder litigation.

brought into the deal only if there is a conflict between parties).[14] It is unlikely, therefore, that even the most highly skilled merger transaction lawyer can confidently evaluates ex ante the litigation skill that will be deployed ex post.

Hypothesis: Construction clauses will be less likely when the lawyers involved have a reputation for providing skilled legal services.

2.6 Attorney familiarity

If the attorneys for both the target and acquirer firm are from the same state, they might have interacted in prior matters and thus be more familiar with each other. Familiarity based on successful interactions in the past implies that the lawyers are less likely to turn quickly to litigation and more likely to attempt to mediate disputes.[15] Lawyers who share a past potentially have a higher level of trust based on those prior contacts and therefore may perceive a lower risk that the other side may be tempted to use doctrines such as *contra proferentem* strategically. In short, lawyers who know each other professionally may not need a construction clause to protect each other from future litigation.

Hypothesis: Construction clauses will be less likely in deals where the attorneys are from the same state and more likely to be familiar with each other based on prior professional interaction.

[14] We are not able to separately test for the reputation of the litigating team. The Vault litigation and merger rankings are given for only for a small sample of law firms. For example, litigation rankings are given for only five law firms, the merger rankings for 10 law firms, whereas the overall ranking was for 100 law firms.

[15] See Klausner (1995); Kahan & Klausner (1997); and Johnston & Waldfogel (2002).

3. DATA, METHODOLOGY, AND VARIABLES

3.1 Data

We began creating our sample of merger and acquisition deals by examining Thomson Securities Data Company's (SDC) Domestic Merger Database from January 2000 through December 2011. This resulted in 109,098 observations. We dropped any transactions where we could not obtain stock return data from the Center for Research in Security Prices (CRSP). This resulted in an initial sample of 8,488 observations. We then examined SDC for these transactions. We dropped deals where SDC showed the name of the acquirer to be the same as the name of the target as in parent-subsidiary mergers (6,681 observations), and when SDC showed 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 went to SEC's Edgar database in order to obtain the firm's Form 8K. We found 268 deals where we could not find the firm's Form 8K. Among those that we found, 351 observations did not have merger agreements. This resulted in a sample of 907 transactions. We then manually examined the merger agreements and supplemented each one with stock return data to create our independent variables. By this process we lost 76 transactions resulting in a final sample of 831 transactions. A summary of our data collection methodology is given in Table 1.

Table 1

3.2 Definitions and sources for variables

Our dependent variable is whether the deal had a construction clause, or not, which we manually collect from the merger agreements. For the various independent variables

used in our regression, we describe below their definition, construction and data sources (see Table 2 for a summary). In order to examine the contextual versus textual interpretation hypothesis, we create a dummy variable *Contextual*, which is set to unity if the state of governing law and forum for the deal is one of the ten states of Alabama, Alaska, Arizona, California, Michigan, New Jersey, New Mexico, Texas, Vermont, and Washington, and zero otherwise. To test the expert court hypothesis, we create two dummy variables, *Delaware* and *New York.* The dummy variable *Delaware* is set to unity if the merger transaction specified Delaware as the state of forum and governing law, and zero otherwise. Similarly, the dummy variable *New York* is set to unity if the merger transaction specified New York as the state of forum and governing law, and zero otherwise. If merger transactions having Delaware as the state of forum and governing law are more likely to have construction clauses than merger transactions having New York as the state of forum and governing law, then we should find that the regression coefficient of *Delaware* should be statistically significantly higher than the regression coefficient of *New York*.

Table 2

To examine the bargaining power hypothesis, we need to calculate the relative size of the target and bidder firms. We define the variable *Relative size* to be the natural logarithm of the market value of the target firm less the natural logarithm of the market value of the bidder firm. These market values are calculated from CRSP on the last day of the estimation period [t =-60] before the merger announcement [t=0].[16]

We next attempt to analyze the firm risk reduction hypothesis, by creating two variables, *A_risk* and *T_risk*, respectively. We proxy for the acquirer's riskiness, *A_risk*, by calculating the standard deviation of its stock return in the year before. For *T_risk*, we

[16] This methodology has also been used by Asquith, Brunner, & Mullins, Jr. (1983).

calculate the standard deviation of the target's stock return also in the year before the merger.

In order to get a proxy for the acquirers and bidders law firm reputation we use two proxies. The first attorney reputation proxy uses the rank of the law firm based on the profits-per-partner of the top 200 law firms. We obtain the name of the law firm from the merger agreements. We then match this law firm name with the rank of the law firm based on the rank of the profits-per-partner of the law firm in the year before the merger. The profits-per-partner rank is obtained for each year from the Am Law 200 series provided by ALM Legal Intelligence. If the law firm is not ranked, we give it a rank of 201.[17] Note that the ranking of profits-per-partner runs from the highest rank of one to the lowest rank of 201. Using the above algorithm, we create a two reputation variables, *A_reputation_PPP* and *T_reputation_PPP*, respectively. The first variable is the reputation rank for acquirers and the second variable is the reputation rank for the target firm.

The second reputation proxy ranks the law firms involved in the merger deal based on the Vault magazine rankings of the top 100 law firms. Once again, we match the name of the law firm on the deal with the rank of the law firm in the year before the merger. If the law firm is not ranked, we give it a rank of 101. We create a two reputation variables, one for acquirers *A_reputation_Vault,* and the second for the target firm *T_reputation_Vault,* respectively.

In order to study the attorney familiarity hypothesis, we examine the merger agreements to obtain the address of the firm's attorneys. The address of the attorneys representing the deal parties, in many cases is not the address of the headquarters of their law firm. We create a dummy variable, *Attorney_familiarity* which is set to unity if attorneys for both the target and acquirer are from the same state, and zero otherwise.

[17] None of our results change if we include a dummy variable for when the law firm is not ranked. These results are not reported.

Finally, we create a number of control variables that might be related to the ex ante choice of negotiating and drafting a construction clause in the merger agreement. The first control variable is *A_serial*, which is set to unity if the acquiring firm has done a merger in the past five years, and zero otherwise. It is possible that serial acquirers are well-versed in the mechanics of a deal and may regard the risk of a *contra proferentem* claim insufficient to justify the costs of reaching agreement on a construction clause. The second control variable is *A_international*, which is set to unity if the acquiring firm is an international firm and zero otherwise. International acquirers might have different preferences and norms than domestic acquirers regarding the need for including or excluding a construction clause. Finally, the third control variable is *Completed*, which is set to unity if the merger was completed, and zero otherwise. If the merger parties perceive construction clauses to be value-maximizing (non-value-maximizing), completed deals are potentially more (less) likely to include a construction clause.

4. EMPIRICAL RESULTS

4.1 Descriptive statistics

In Table 3, we present the descriptive statistics of the dependent and independent variables that we will use in our regression. We begin by documenting the incidence of construction clauses in our sample. We find that construction clauses are common to many merger agreements, with 194 out of 831 deals (23.5%) having a construction clause. We find 47 deals (5.7%) are governed by the the law of one of the ten states whose contract law follows a contextualist interpretive style. Delaware is chosen as the preferred court for law and forum in the majority of cases (70%), distantly followed by New York (8.2%). These results suggest that there does not seem to be a significant flight from Delaware for mergers between publicly traded firms and is consistent with the results of Cain and Davidoff (2012).

Table 3

When we examine the relative size and economic power of the two merging firms, we find that the average target firm is 10% of the market capitalization of the bidder firm. We also find that acquirers have annual standard deviation of stock returns of 12.9% (standard deviation based on daily return data times 10,000 times square root of 252 divided by 240) and targets have an annual standard deviation of stock returns of 19.2%, suggesting that acquirer firms have a lower stock return risk than target firms.

When attorney reputation is based on profits-per-partner, we find that the median rank of the acquirer law firm's reputation to be 55 out of 201, which is higher than the median rank of 68 of the target law firm's reputation. (Note that a lower number reflects a higher rank for the law firm.) A similar pattern is found for law firm reputation based on Vault magazine ranks.

We find that around 32% of the merger partners employ attorneys from law firms that are located in the same state. A number of deals, 258 or 31%, have acquirers who have made at least one other acquisition in the past five years. Only 5% of the deals involved international acquirers and most of the deals (92%) were completed.

We have used two proxies for the reputation of the deal lawyers, one based on the rank of the law firm using profits-per-partner, and the other based on the rank of the law firm using Vault magazine. In Table 4, we present the Spearman correlation coefficients which are all found to be statistically significant at the one-percent level of significance. We find that the two proxies for law firm reputation are highly correlated. For example, in the case of acquirers, law firm reputation based on profits-per-partner has a correlation coefficient of 0.81 with law firm reputation based on Vault magazine. Similarly, for target firms, law firm reputation based on profits-per-partner has a correlation coefficient of 0.76

with law firm reputation based on Vault magazine. Accordingly, we use these two proxies for the reputation of the deal lawyers separately in all our regression specifications.

Table 4

4.2 Determinants of construction clauses

We now estimate a Probit regression model to determine the ex ante choice of merger partners to include a construction clause in their merger agreement. The results of this estimation are given in Table 5. Panel A presents the marginal regression estimates[18] and corrected standard errors using the Huber-White sandwich estimators that correct for lack of normality and heteroscedasticity. The regression estimates are the marginal effects of the independent variable. In Panel B, we present the results of an *F*-test that the multiple regression coefficients are jointly equal to zero.

Table 5

There are three columns in Table 5. The first column shows the results where we use the law firm rank based on profits-per-partner, and the second column uses law firm rank based on Vault magazine. In both columns (1) and (2), we include all our independent variables. Examining column (1), we find that deals whose choice of forum and law are a state that has contextualist rules of interpretation has a statistically significant positive relationship with the merger agreement having a construction clause. The marginal regression coefficient on *Contextual* is 0.226 and is statistically significant at the one-percent level. This suggests that changing the choice of forum and law from a textualist to a contextualist state raises the probability of having a construction clause by 0.226. Accordingly, lawyers for deal parties are more likely to write a contract with a construction

[18] Given that the Probit regression model has the dependent variable as a dichotomous variable, we calculate the marginal effect of each independent variable on the probability of including a construction clause to be evaluated at the means (STATA command "margins, dydx(*) at means").

clause if subsequent litigation will be in a contextualist court that is open to a more expansive consideration of factors extrinsic to the written agreement.

We next examine the expert court hypothesis. The marginal regression coefficient on *Delaware* is 0.179 and is statistically significant at the one-percent level. This suggests that deals that choose to have their merger agreements litigated before the expert Chancery Court in Delaware have a higher likelihood to include an explicit construction clause. No such statistically significant effect is found for *New York*, suggesting that selecting the textualist state of New York for any subsequent litigation has no impact on the probability of including a construction clause. A χ^2–test finds that the regression coefficient on *Delaware* is greater than the regression coefficient on *New York* at the one-percent level of statistical significance.

When we examine *Relative size* we find a marginal regression coefficient of -0.016, which is statistically significant at the ten-percent level. This shows marginal evidence for the bargaining power hypothesis that economically powerful firms that acquire smaller enterprises are more likely to negotiate for a construction clause in the merger agreement.

When we examine the firm risk variables we find no evidence for the hypothesis that less risky acquirers (*A_risk*) write a construction clause to lower their risk from future litigation. However, we find that high-risk target firms (*T_risk*) have a statistically positive effect on the likelihood of the agreement including a construction clause. This result may suggest that parties agree on a construction clause because they anticipate a higher probability of future litigation when the target firm is a riskier enterprise.

The attorney reputation hypothesis predicts that more skilled attorneys are more (or less) likely to include a construction clause in the merger agreement. When we examine the profit-per-partner rank of the law firm for both the acquirer (*A_reputation_PPP*) and target (*T_reputation_PPP*) firms, we find a statistically insignificant effect on the

likelihood of the agreement including a construction clause. This suggests that the relative skill of the deal lawyers has no impact on the probability of negotiating for a construction clause in the merger agreement.

The attorney familiarity variable (*Attorney familiarity*) are statistically insignificantly related to the likelihood of including a construction clause. This suggests no evidence for the hypothesis that attorneys from the same state are less likely to litigate, owing to a higher level of trust with each other or with the firm they represent, and if they do litigate, that they are less likely to advance strategic arguments.

We now examine the impact of our control variables. We find that serial acquirers (*A_serial*) and international bidders (*A_international*) are statistically insignificantly related to the likelihood of including a construction clause. When we examine whether the deal was completed or not (*Completed*) we find no evidence that incomplete deals have a higher likelihood of including a construction clause.

In Panel B, we present the results of an *F*-test that the multiple regression coefficients under the respective hypotheses are jointly equal to zero. An *F*-test shows that the expert court hypothesis is statistically significant at the one-percent level, but we know from Panel A that this result is driven by Delaware and not New York. Similarly, we find that firm risk is statistically significant at the one-percent level, and we know from Panel A that this result is driven by the target's risk and not the acquirers. Consistent with the results of Panel A, we find that the attorney reputation and control variables are insignificantly related to the likelihood of including a construction clause.

In column (2) we repeat the above analysis using the attorney reputation proxy based on Vault magazine. Once again we find consistent results: contextual states, Delaware, and target risk are statistically significantly related to the likelihood of having a construction clause in the merger agreement. Once again, a χ^2–test finds that the regression

coefficient on *Delaware* is greater than the regression coefficient on *New York* at the five-percent level of statistical significance.

In column (3), we construct a parsimonious model of the statistically significant variables (at the ten-percent level) that we found in columns (1) and (2). Relative size which were only marginally statistically significantly related at the ten-percent level in column (1) loses its statistical significance in column (3). The results in this column are reassuring in that our regression specification does not suffer from unobserved collinearity.

In summary, we find a higher likelihood of having a construction clause in the merger agreement in deals where the choice of forum and law are one of the ten contextualist dispute resolution states or the expert court of Delaware, or when the target is a high-risk firm. We find no statistically significant impact on the likelihood of having a construction clause because of lawyer reputation or familiarity, New York as the choice of law and forum, when a large acquirer takes over a small target, international or high-risk acquirers, or whether the deal was completed.

4.3 Value Creation (Event Study)

In order to check if construction clauses create value, we calculate the value created on announcement of the merger. The announcement date of the merger is obtained from SDC. We begin by conducting an event study to calculate the abnormal returns for both the target and acquirer firms, respectively. Value is defined as the weighted average of the five-day (or one-day) cumulative abnormal returns of the target and acquirer firm, with the portfolio weights being the market capitalization of target and acquirer firm in the sixty days before the merger announcement.[19]

[19] Supra footnote 16.

We estimate a system of equations that takes into account the endogenous choice of including or excluding a construction clause in the merger agreement. We define the system of equations below:

$$\text{Merger Value} = f(\text{construction clause}, \textit{Relative size}, \textit{Cash}) \quad (1)$$

$$\text{Construction clause} = g(\textit{Contextual}, \textit{Delaware}, \textit{T\_risk}) \quad (2)$$

Note that that we estimated equation (2) above by using a Probit regression (the results of which were given Table 5). In order to calculate value created in the merger in equation (1), we use the abnormal returns earned by firms around the merger announcement date (t=0) using the standard event study methodology. Let the return generating process for firm *i* during time *t* be given by the market model $r_{it} = \alpha_i + \beta_i r_{mt} + \varepsilon_{it}$, where r_{it} is equal to stock returns for firm *i* at time *t*, r_{mt} is equal to the stock returns on the CRSP value-weighted market index at time *t*, α_i is equal to the regression estimate of the intercept of the market model, and β_i is equal to the regression estimate of the slope coefficient of the market model. This equation is estimated for 240 days before the event date [-300, -60] by regressing r_{it} on r_{mt}. The OLS regression estimates α_i and β_i are hence obtained. These estimates are then used in for each of the event days separately, and follows $A_{it} = r_{it} - \hat{\alpha}_i - \hat{\beta}_i r_{mt,}$ where A_{it} is equal to stock abnormal returns over the market returns of firm *i* at time *t.* We sum the prediction errors over all firms n=1…N, so as to average out the non-systematic factors not related to the merger announcement.

Let AAR_t be the average daily abnormal return for each day *t,* denoted as $\text{AAR}_t = \frac{1}{N}\sum_{i=1}^{n} A_{it}$).[20] In Panel A of Table 6, we calculate the mean and median daily abnormal returns. We find statistically significant positive abnormal returns especially around the

[20]The estimate of variance of AAR_t is $\hat{\sigma}^2_{\text{AAR}} = \frac{\sum_{t_b}^{t_e}(\text{AAR}_t - \overline{\text{AAR}})^2}{D-2}$, where the market parameters are estimated over the estimation period of $D = t_b - t_e + 1$ days and $\overline{\text{AAR}} = \frac{\sum_{t_b}^{t_e} \text{AAR}_t}{D}$. The t- statistic for day *t* in event time is $t - \text{statistic} = \frac{\text{AAR}_t}{\hat{\sigma}_{\text{AAR}}}$.

announcement date. To ensure that we do not lose any announcement period returns we calculate two sets of cumulative abnormal returns (CAR). They are five days before, and five days after, the announcement date (CAR[-5, +5] = $\sum_{t=-5}^{5} \widehat{AAR_t}$); and one day before, and one day after, the announcement date (CAR[-1, +1] = $\sum_{t=-1}^{1} \widehat{AAR_t}$), respectively. In Panel B, we find that the average and median CARs for both [-5,+5] and [-1, +1] are positive and statistically significant. These results show that mergers do create value around the merger announcement date.

Table 6

We now estimate the system of equations given by equations (1) and (2). We know from Asquith, Bruner and Mullins (1983)[21] that *Relative size* is positively related to higher cumulative abnormal returns. Travlos (1987)[22] shows that acquisitions whose medium of exchange is exclusively cash earns higher cumulative abnormal returns. We create a dummy variable *Cash*, which is set to unity if the deal involves only cash as the medium of exchange and zero otherwise. Accordingly, we include the variables *Relative size* and *Cash* in equation (1). Endogenizing for construction clauses using equation (2), we present the results of the two-stage Least Squares Regression in Panel C. We find construction clauses to have an statistically insignificant relationship on merger value, when merger value is defined using either CAR[-5, +5] or CAR[-1,+1], respectively. Consistent with the results of Asquith, Bruner and Mullins (1983) and Travlos (1987), we find *Relative size* and *Cash* to be positive and statistically significantly related to merger value.

5. CONCLUSION

Construction clauses are terms in merger agreements stipulating that both parties have been represented by counsel during the negotiation and drafting of the merger

[21] See footnote 16.

22 See Nicholas G. Travlos , Corporate Takeover Bids, Methods of Payment, and Bidding Firms' Stock Returns, J. of Fin., 42, 943-63, (1987).

agreement, and waiving the application of any law or rule of construction providing that ambiguities in the agreement will be construed against the drafting party. The apparent purpose of the clause is to inoculate the parties (or at least one of the parties) against ex post litigation risk, in particular the risk that a court may be persuaded to invoke the maxim of *contra proferentem* to justify an interpretation of a term in the merger agreement against the interest of the party found to have been the principal drafter. This risk is not trivial. For example, the material adverse change clause, affirming that that no material adverse change in the target's business has occurred, is one of the terms most susceptible to an interpretive dispute based on the arguably ambiguous language used in the clause (Gilson & Schwartz (2005)). Theory would predict, therefore, that parties to merger agreements, especially economically powerful acquirers, would wish to foreclose these arguments; this is particularly the case in a litigation dispute with a smaller target who is claiming that the adverse event in question was not covered by the merger agreement. The risk that this argument might succeed is even more salient in those jurisdictions that are amenable to looking beyond the plain language of the agreement to surrounding circumstances to inform the meaning of arguably ambiguous terms.

Analyzing a large sample of merger and acquisition transactions over an 11-year period, this paper is the first to empirically examine the incidence of construction clauses, to test whether (and when) parties expend costs in negotiating and drafting a construction clause in response to the expected back end costs of enforcement and litigation. We find that construction clauses are quite common in public company merger agreements: parties write such a clause 23.6% (196 out of 831) of deals in the sample. We also find a higher likelihood of having a construction clause in the merger agreement in deals where the choice of forum and law are one of the ten states that adopt a contextualist approach to contract interpretation, or when the choice of governing law is the expert Chancery Court of Delaware, or when the target is a high-risk firm, The first two results suggest that lawyers for deal parties are more likely to write an explicit construction clause so as to minimize expected enforcement costs when disputes will be adjudicated by courts that

follow a more expansive approach to contract interpretation. The second result is weakly consistent with the assumption that high risk targets are more likely to suffer adverse events, leading to litigation over the meaning of terms such as the MAC clause in the agreement.

We find no statistically significant impact, however, on the likelihood of the agreement having a construction clause because of the reputation of the deal lawyers or the familiarity that opposing counsel may have with each other. Similarly, there are no statistically significant effects from the selection of New York as the forum and law state, or whether an economically powerful bidder is acquiring a small target, or whether the acquirers are international or high-risk firms, or whether the deal was completed. Finally, controlling for the endogenous choice of including a construction clause, we find no evidence that the inclusion of this contract term changes the value of the combined firm on merger announcement.

Table 1: Sample Creation

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-subsidiary 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	(268)
Dropped if no merger agreement in form 8K	(351)
Dropped if any independent variables in regression are missing	(76)
Final Sample	831

Table 2: Definitions and Sources

Variable	Definition {Source}
Construction clause	Dummy variable set to unity if the deal specified a construction clause, and zero otherwise.{Merger agreement}
Contextual	Dummy variable set to unity if the state of law and forum is one of the ten contextual interpretation states, Alabama, Alaska, Arizona, California, Michigan, New Jersey, New Mexico, Texas, Vermont, and Washington, and zero otherwise.{Merger agreement}
Delaware	Dummy variable set to unity if the state of law and forum is Delaware, and zero otherwise. { Merger agreement }
New York	Dummy variable set to unity if the state of law and forum is New York, and zero otherwise. { Merger agreement }
Relative size	Natural logarithm of target's market value less natural logarithm of acquirer's market value. {CRSP}
A_risk	Standard deviation of the acquirer's stock returns in the year before the merger. {CRSP}
T_risk	Standard deviation of the target's stock returns in the year before the merger. {CRSP}
A_reputation_PPP	Rank based on profits-per-partner for the acquiring firm's lawyer. Rank goes from high reputation [1], to low reputation [200]. If the law firm is not ranked, we give it a rank of 201. {Merger agreement and Am Law 200 series}
T_reputation_PPP	Rank based on profits-per-partner for the target firm's lawyer. Rank goes from high reputation [1], to low reputation [200]. If the law firm is not ranked, we give it a rank of 201. {Merger agreement and Am Law 200 series}
A_reputation_Vault	Rank based on Vault for the acquiring firm's lawyer. Rank goes from high reputation [1], to low reputation [100]. If the law firm is not ranked, we give it a rank of 101. {Merger agreement and Vault 100 series}
T_reputation_Vault	Rank based on Vault for the target firm's lawyer. Rank goes from high reputation [1], to low reputation [100]. If the law firm is not ranked, we give it a rank of 101. {Merger agreement and Vault 100 series}
Attorney familiarity	Dummy variable set to unity if attorneys for both the target and acquirer firm are from the same state, and zero otherwise. {Merger agreement}
A_ serial	Dummy variable set to unity if bidder is a serial acquirer, and zero otherwise. {SDC}
A_ international	Dummy variable set to unity if bidder is an international acquirer, and zero otherwise. {SDC}
Completed	Dummy variable set to unity if merger completed, and zero otherwise. {SDC}

Table 3: Descriptive Statistics

Variable	Mean	Median	Std. Dev.
Construction clause	0.235	0	0.425
Contextual	0.057	0	0.231
Delaware	0.669	1	0.471
New York	0.082	0	0.274
Relative size	-2.28	-2.06	1.79
A_risk	12.91%	9.74%	31.29%
T_risk	19.17%	5.18%	26.43%
A_reputation _PPP	80.8	55	73.6
T_reputation _PPP	90.0	68	72.3
A_reputation_Vault	53.3	49	40.7
T_reputation_Vault	60.1	63	38.9
Lawyer familiarity	0.32	0	0.47
A_ serial	0.31	0	0.46
A_ international	0.05	0	0.22
Completed	0.92	1	0.00

See Table 2 for variable definitions.

Table 4: Spearman Correlation Coefficients of Lawyer Reputation Variables

	A_reputation_PPP	*A_ reputation_Vault*	*T_reputation _PPP*	*A_ reputation_Vault*
A_reputation _PPP	1			
A_reputation_Vault	0.808	1		
T_reputation _PPP	0.318	0.319	1	
T_reputation _ Vault	0.2791	0.282	0.765	1

See Table 2 for variable definitions. All Spearman correlations are statistically significant at the one- percent level.

Table 5: Probit Model for Choice of Construction Clause

	Reputation proxied by: ranking of profits-per-partner	Reputation proxied by: ranking of Vault magazine	Parsimonious model
	(1)	(2)	(3)
Panel A: Regression coefficients & standard errors			
Contextual	0.226 (0.07)[a]	0.227 (0.07)[a]	0.216 (0.07)[a]
Delaware	0.179 (0.05)[a]	0.197 (0.05)[a]	0.158 (0.04)[a]
New York	0.053 (0.07)	0.077 (0.07)	
Relative size	-0.016 (0.01)[c]	-0.015 (0.01)	-0.006 (0.01)
A_risk	10.76 (7.92)	9.52 (7.37)	
T_risk	14.12 (6.53)[b]	13.95 (6.40)[b]	20.53 (5.47)[a]
A_reputation _PPP	0.000 (0.00)		
T_reputation _PPP	0.000 (0.00)		
A_reputation_Vault		0.000 (0.00)	
T_reputation_Vault		0.001 (0.00)	
Attorney familiarity	0.028 (0.03)	0.040 (0.03)	
A_ serial	-0.044 (0.04)	-0.041 (0.03)	
A_ international	0.051 (0.06)	0.058 (0.06)	
Completed	-0.082 (0.05)	-0.077 (0.05)	
Constant	-1.27 (0.25)[a]	-1.52 (0.26)[a]	-1.33 (0.13)[a]
Panel B: *p*-values for variables jointly equal to zero			
Expert courts	0.000[a]	0.000[a]	
Firm riskiness	0.001[a]	0.002[a]	
Attorney reputation	0.844	0.168	
Control variables	0.184	0.212	
Pseudo R^2	0.056	0.062	0.046
N	831	831	831

[a] statistically significant at 1% level; [b] statistically significant at 5% level; and [c] statistically significant at 10% level, respectively.

* Parsimonious model includes only those variables in columns (1) and (2) that are statistically significant at the 10% level.

See Table 2 for variable definitions.

Table 6: Value Creation (Abnormal Returns) Earned on Merger Announcement

Panel A: Daily Abnormal Returns		
Date	Mean (standard errors)	Median (standard errors)
-5	0.08% (0.001)	-0.04% (0.0006)
-4	0.21% (0.001)[b]	0.04% (0.0006)
-3	0.11% (0.001)	-0.05% (0.0006)
-2	0.05% (0.001)	-0.06% (0.0006)
-1	0.12% (0.001)	-0.03% (0.0006)
0	1.07% (0.001)[a]	0.42% (0.0006)[a]
+1	0.36% (0.001)[a]	0.06% (0.0006)
+2	0.09% (0.001)	-0.05% (0.0006)
+3	-0.11% (0.001)	-0.09% (0.0006)[c]
+4	-0.02% (0.001)	-0.05% (0.0006)
+5	-0.12% (0.001)	-0.18% (0.0006)[a]

Panel B: Cumulative Abnormal Returns [CAR]		
	Mean (standard errors)	Median (standard errors)
CAR[-1,+1]	1.55% (0.001)[a]	0.79% (0.0006)[a]
CAR[-5, +5]	1.85% (0.001)[a]	1.04% (0.0006)[a]

Panel C: Two Stage Least Square regression on Construction Clause and Other Independent Variables.		
	CAR [-1, +1]	CAR [-5, +5]
	Coefficient (standard errors)	Coefficient (standard errors)
Construction clause (predicted)	0.009 (0.041)	0.082 (0.059)
Relative size	0.009 (0.002)[a]	0.014 (0.003)[a]
Cash	0.028 (0.007)[a]	0.027 (0.010)[a]
Constant	0.028 (0.008)[a]	0.021 (0.011)[a]
R^2	0.032	0.030

[a] statistically significant at 1% level; [b] statistically significant at 5% level; and [c] statistically significant at 10% level, respectively.

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