

Contents lists available at [ScienceDirect](#)

Finance Research Letters

journal homepage: www.elsevier.com/locate/frl

Shareholder rights in mergers and acquisitions: Are appraisal rights being abused?

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ARTICLE INFO

Article history:

Received 18 October 2016

Accepted 31 December 2016

Available online xxx

JEL classification:

G34

K22

Keywords:

Appraisal rights

Mergers and acquisitions

Takeover law

ABSTRACT

Appraisal rights grant dissenting shareholders in an acquisition the right to petition the court to determine the value of their shares. These rights can protect shareholders from acquisitions below fundamental value or can be abused by opportunistic investors. We examine the use of appraisal rights and find the evidence is most consistent with appraisal rights functioning as recourse when the target firm is sold below fundamental value.

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1. Introduction

Shareholder rights protect investors from adverse events that arise due to the incomplete contracting between shareholders and managers. Shareholder rights may not be strictly beneficial though. Because the enumeration of shareholder rights is incompletely specified in the legal code, there may be scope for those rights to be abused. In this paper we examine the role of shareholder rights in merger and acquisition activity and investigate how the right of appraisal is being used by financial market participants.

After an acquisition, shareholders of the target firm have a limited number of remedies when a contracting failure is suspected and a shareholder believes the firm was sold below fundamental value. One of those remedies is the right of appraisal, which allows a shareholder to petition the court to determine the fundamental value of the firm, thereby bypassing the suspected failure in the market pricing mechanism.

While appraisal rights may protect shareholders, they also may be abused by opportunistic shareholders. For example, opportunistic shareholders may choose to bypass the market pricing mechanism simply because they believe it to be a profitable investment strategy.¹ The right of appraisal may be abused in other ways. In the contentious Dell Inc acquisition, Carl Icahn urged other shareholders to perfect their appraisal rights because he believed “there will be significant pressure on Michael Dell and Silver Lake to resolve the appraisal rights [due to the large number of shareholders seeking appraisal], and possibly seek a settlement”.²

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¹ Certain hedge funds have been accused of abusing appraisal rights by implementing this strategy; a strategy which has become known as “appraisal arbitrage.”

² <https://www.sec.gov/Archives/edgar/data/826083/000092846413000167/delldfan14a071013.htm>.

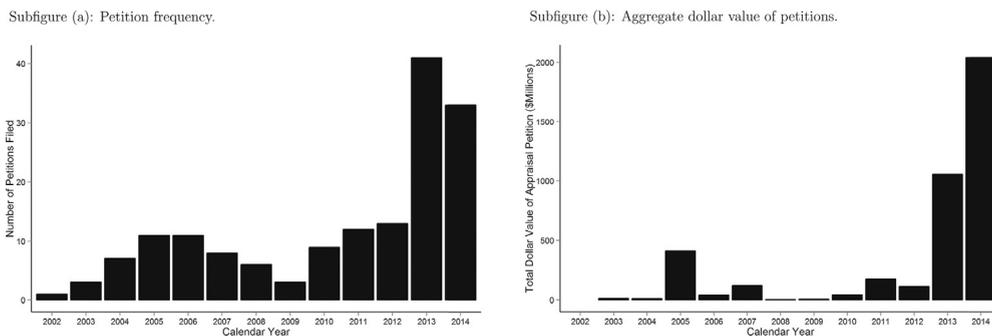


Fig. 1. Appraisal petition time series.

In this paper we ask the following question: are appraisal rights generally being used to remedy contracting failures in the merger negotiation process such that the target is acquired below fundamental value or are appraisal rights generally being abused by opportunistic investors? Our findings are consistent with the former – appraisal rights are generally being used to remedy contracting failures.

As demonstrated in Fig. 1, appraisal rights are an increasingly relevant issue in the market for corporate control with the frequency of petitions and aggregate dollar value substantially increasing in recent years.³ This increase has not gone unnoticed and a nascent literature has started to explore this phenomenon. This literature includes work by Korsmo and Myers (2014, 2015) and Jiang et al. (2016).

2. Data and methodology

For this study we gather all appraisal petitions filed with the Delaware Court of Chancery between January 2003 and May 2015 through CourtLink, a LexisNexis database. In total we collect 275 petitions filed on behalf of 622 beneficial shareholders. We match these petitions to transactions available in the SDC Platinum database, and focus on publicly listed targets with market capitalization greater than \$10 million. This leaves us with a sample of 159 petitions from 116 unique transactions.

We use a matched sample methodology and match each petitioned target to a non-petitioned target based on total assets, three-digit SIC code, and the restriction that the matched transaction is announced within one year of the petitioned transaction.⁴

We do not find significant differences in financial or operating characteristics (Table 1, Panel A) or in deal characteristics (Table 1, Panel B), but find substantial differences in the initial and final premia (17.6% and 15.7%). We do not find a significant difference in the incidence of revision or the revision amount, which is inconsistent with the threat of the use of appraisal rights being an effective strategy by opportunistic investors. We observe a difference in all cash transactions but note that cash consideration is required to file an appraisal petition.

3. Why are certain deals targeted for appraisal?

Table 2 estimates a conditional logit model for whether an appraisal petition was filed, controlling for target firm characteristics, deal characteristics, and year fixed effects (Chamberlain, 1980) to account for evolving case law that may affect the exercise of appraisal rights.

We find the deal premia is a statistically significant determinant of whether a deal is petitioned, consistent with dissenting shareholders believing the premia is inappropriately low, *ceteris paribus*. We do not find that deal characteristics consistent with an overt conflict of interest (e.g., going private or being acquired by a financial acquirer) are significantly associated with higher odds of a deal being petitioned.

Because overt conflicts of interest are likely to invite fiduciary breach class-action litigation – a separate legal channel – we instead consider “benign” frictions in the merger negotiation process inadvertently introduced by target firm leadership. In particular, we examine firm-specific experience and board busyness as two benign frictions.

Merger negotiations involve target firm leadership translating projected firm operations into an estimated firm value and an associated reservation price at which they will not sell the firm below. We postulate that directors and CEOs with

³ We focus exclusively on Delaware due to its importance in corporate law.

⁴ Due to data availability in Compustat our final sample is 92 petitioned transactions. Additionally, 21 (4) percent of the petitioned sample we match on two-digit (one-digit) SIC code.

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