



Shareholder wealth effects and bid negotiation in freeze-out deals: Are minority shareholders left out in the cold? ☆

Thomas W. Bates^{a,*}, Michael L. Lemmon^b, James S. Linck^c

^aEller College of Management, University of Arizona, Tucson, AZ 85721, USA

^bDavid Eccles School of Business, University of Utah, Salt Lake City, UT 84112, USA

^cTerry College of Business, University of Georgia, Athens, GA 30602 USA

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Abstract

This paper examines the shareholder wealth effects of bids by controlling shareholders seeking to acquire the remaining minority equity stake in a firm, deals commonly referred to as minority freeze-outs. Minority claimants in freeze-out offers receive an allocation of deal surplus at the bid announcement that exceeds their pro rata claim on the firm. An analysis of bid outcomes and renegotiation indicates that minority claimants and their agents exercise significant bargaining power during freeze-out proposals. Overall, our results suggest that legal standards and economic incentives are sufficient to deter self-dealing by controllers during freeze-out bids.

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*Corresponding author. Fax: +1 520 621 1261.

E-mail address: batest@email.arizona.edu (T.W. Bates).

1. Introduction

Few subjects in applied corporate finance generate as much practitioner debate as the valuation of minority equity claims in US corporations. The issue is particularly important when a corporation's controlling shareholder bids for the remaining minority equity stake in the firm, deals commonly referred to as minority freeze-outs. Concerns associated with minority shareholder welfare in freeze-out bids have frequently garnered the attention of the business press and legal community because the pricing of minority shares does not emerge from an arm's-length negotiation between independent parties and can reflect a conflict inherent with disparate ownership interests.¹

The courts have recognized potential limitations on the objectivity of controlling shareholders and a target firm's directors during freeze-out negotiations. Correspondingly, legal doctrine concerning the fiduciary obligations of controlling shareholders and their directors during freeze-out bids has developed considerably over the last decade. Judicial review of freeze-out transactions has applied a fairness standard that discourages coercive bids while encouraging full information arm's-length negotiation between claimants. Nevertheless, legal protections and economic incentives could be insufficient to fully resolve conflicts of interest between controllers and the agents charged with representing minority shareholders during freeze-out negotiations.²

To summarize the dynamics between the legal and economic environment in freeze-out bids, we propose two alternative theories concerning the outcomes for minority shareholders in these bids. The first is a theory of bid capture. This theory suggests that controllers are able to capture a disproportionate share of the gains in freeze-out transactions by structuring bids that minimize vigorous negotiation with minority claimants who lack sufficient board representation or efficient legal recourse or both. The second is a minority bargaining power theory. Under this theory we posit that, despite potentially incomplete legal protections for minority shareholders, the incentives of participants and economic conditions associated with deal structure insulate minority shareholders from self-dealing by controlling shareholders.

To address these hypotheses, we empirically examine bid characteristics and deal outcomes for a sample of freeze-out proposals involving US public corporations between 1988 and 2003. We consider both the indirect evidence pertaining to changes in shareholder wealth during freeze-out bids and direct evidence concerning the prevalence and tenor of explicit bid negotiation during these transactions. Our analysis incorporates two sets of benchmark transactions: bids proffered by bidders holding non-controlling equity toeholds in a target (henceforth referred to as minority toehold bids), and bids involving bidders with no pre-bid equity stake in the target (henceforth referred to as no-toehold bids). While transactions involving the transfer of control provide a revealing benchmark for negotiation, they likely yield systematically different wealth changes and include significant control premiums relative to freeze-out bids, potentially confounding

¹The acquisition of minority shares is not uncommon. These transactions frequently occur as a second-step or clean-up merger following a tender offer but are rarely challenged given an established fair price. We exclude clean-up transactions from the analysis that follows and focus instead on bids by majority shareholders that have held their stake for a minimum of six months prior to the freeze-out offer.

²"The controlling stockholder relationship has the potential to influence, however subtly, the vote of minority stockholders in a manner that is not likely to occur in a transaction with a non-controlling party." See *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d (Del, 1994).

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