International Review of Law and Economics 36 (2013) 48–58

Contents lists available at ScienceDirect

International Review of Law and Economics

The economics of minority freezeouts: Evidence from the courtroom

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ARTICLE INFO

Article history:
Received 8 February 2010
Received in revised form 12 March 2013
Accepted 22 April 2013

JEL classification:
G38
K22

Keywords:
Law and economics
Legal enforcement
Stockholder protection
Minority freezeout

ABSTRACT

We analyze minority freezeout offers in a legal environment where minority stockholders can reject the offer and ask the court to value their nontendered stock. This regulatory setting allows us to observe the disciplining effect of legal enforcement on stockholder behavior. We find that minority stockholders reject about one out of ten freezeout offers, and that rejection is more likely when the bidder has controlled the firm for quite some time before the offer. Rejected offers take on average around three years to be settled in court, and litigation costs are almost never paid by minority stockholders. The court mostly prices rejected offers above the offer price, particularly when the firm is private, when the bidder has controlled the firm for an extensive period before the offer, and when the case is large. These findings suggest that minority stockholders consider most freezeout offers commensurate with the level of legal stockholder protection as enforced by the courts. The majority stockholder tends to underestimate the legal protection of minority rights in settings where these rights are particularly vulnerable to exploitation. Nevertheless, minority stockholders who take their case to court often face years of waiting, and for a highly unpredictable litigation return.

1. Introduction

A minority freezeout occurs when a firm's majority stockholder exercises the option to buy the minority stock at a price set by the majority. This right is granted by law when the majority obtains a certain minimum fraction of the equity, which varies between 50% and 95% across different countries.[1] The purpose of freezeout law is partly to protect the majority (the bidder) from a free-riding minority (Grossman & Hart, 1980), partly to protect the minority (the target) from a power-abusing majority (Bebchuk & Kahan, 2000). Hence, an important regulatory concern is whether freezeout law ensures efficiency for society and fairness for the two parties (Amihud, Kahan, & Sundaram, 2004; Maug, 2006). In particular, a key issue is how ex post enforcement of the law in court disciplines parties' behavior ex ante, that is, when the majority sets the freezeout price and the minority decides whether to accept or reject the offer. We provide novel empirical insight into this issue by being the first to observe in detail how the minority stockholder chooses between accepting and rejecting the freezeout offer and how the court values the minority shares in rejected offers.

We find that 11% of all freezeout offers are rejected by the minority and hence taken to court. Offer rejection is independent of the bid premium (the freezeout price relative to the stock price) and of firm size, but is much more common when the bidder has controlled the firm for at least one year before the offer. We call such freezeouts slow, as opposed to fast. Half the offers are rejected in slow freezeouts, as opposed to just one tenth when the freezeout is fast.

The median return from litigation in excess of the riskless rate is 6%. This litigation premium is also positive in roughly three of four cases. Hence, the offers taken to court mostly end up being valued well above the freezeout price. Consistent with our finding for the minority's propensity to reject, this tendency by the court to discipline the majority ex post is stronger when the freezeout is slow, although the relationship is statistically stronger for the accept/reject decision than for the court's enforcement decision in rejected offers. The court also makes higher valuations relative to the freezeout price when the firm is privately held rather than publicly listed.

These findings suggest that majority stockholders generally make freezeout offers that the minority regard as being commensurate with stockholder protection levels currently enforced by the courts. However, the majority tends to underestimate the legal protection of minority stockholder rights when these rights are particularly easy to violate through the majority's extraction of private

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[1] Judging from Maug (2006), (90)% is the typical threshold. For instance, Norway, Sweden, and the United Kingdom have 90%, and Germany has 95%. The US threshold is 50% for so-called freezeout mergers and 90% for so-called short-form mergers (Bates et al., 2006).

0144-8188/$ – see front matter
http://dx.doi.org/10.1016/j.irle.2013.04.007

benefits. These settings are characterized by the lack of a liquid market place for the firm's stock (private firm) and a long control period for the bidder before the freezeout offer is made (slow freezeout).

This evidence suggests that a well-functioning discipline of the majority's behavior at the offer stage of the freezeout process requires a well-functioning discipline by the court at the litigation stage. This seems particularly true when the majority is strongly tempted to abuse power. The firm's listing status (public/private) and the length of the bidder's control period before the bid (freezeout speed) are keys to identifying settings with high abuse potential.

These results also reflect that independent of stockholder protection levels in the court's legal enforcement, the majority and minority stockholders in our sample firms mostly have similar views on the potential outcome of a court case if the offer is rejected. As shown by Priest and Klein (1984), the majority's incentives to litigate are fewer the less the two parties disagree and the more certain they are about the outcome of a court case. Both characteristics reduce the difference between the offered freezeout price and the predicted valuation outcome in court.

Our evidence suggests that this difference in beliefs between the parties is smaller when the majority has just recently acquired control of the firm. A possible reason is that bidders who have controlled the firm a long time before the offer date may have reduced the stock's liquidity considerably because of the bidder's large, untraded share block. Such bidders may also be better positioned to time the offer date based on private information about the firm's intrinsic value (Bebchuk & Kahan, 2000). Both possibilities may make the court value the minority stock with less regard than usual for both the freezeout price and the stock price around the offer date. Consequently, slow freezeouts may leave more room for court discretion and produce more uncertainty for the parties about the court's valuation outcome. This increased uncertainty increases the incentives to take the case to court.

Unlike the extant literature (Dodd & Ruback, 1977; DeAngelo, & Rice, 1984; Holderness & Sheehan, 1988; Bates, Lemmon, & Linck, 2006), our paper studies a regulatory regime where the court explicitly values minority shares. We analyze minority freezeouts in Norway, where any minority stockholder has the right to reject the majority's offer (the freezeout price) and take the case to court. The court hears the two parties and delivers a verdict in terms of a value per minority share (the court price). The majority must pay the court price to the nontendering minority at the closure of the case.

Our basic sample is the population of all freezeout transactions in public and private firms valued by the court from when the freezeout law was passed by Parliament in 1976 to the end of the sample period in 2010. We first compare a subsample of these rejected offers with the offers that were accepted by the minority, that is, not taken to court. Specifically, we estimate the determinants of the decision to accept or reject the offer. Subsequently, we focus on the rejected offers by analyzing the economic consequences for the minority of turning down the known freezeout price and of instead receiving a claim to an uncertain court price at an uncertain future time. Since the majority's situation is the mirror image, our estimates also show the economics for the majority of using the courts to settle the conflict with a nontendering minority.

We find that the bidder's control in the firm before the freezeout is the most important determinant of the accept/reject outcome, while the firm's listing status plays this role for the court's valuation outcome in rejected offers. The median litigation premium of rejecting the freezeout price and waiting for the uncertain court price is 6%, being positive in about three quarters of the verdicts. Although this litigation premium varies widely from verdict to verdict, the premium reflects a risk about valuation outcomes which is unsystematic. Therefore, a positive premium represents abnormal returns from litigation, provided the minority stockholder is well diversified and not liquidity constrained.

The observed litigation premium shows that the majority systematically underestimates the value of the minority stock as implied by the extant enforcement of minority protection law. The evidence also suggests that most minority stockholders do not behave opportunistically by litigating excessively. If they had, the average litigation premium would not have been positive. This is a remarkable result, because we also find that minority stockholders very seldom pay their out-of-pocket litigation costs. Hence, minority stockholders seem to rationally take into account the potential court outcome when deciding on whether to accept.

We show that the court's disciplining behavior depends on several case characteristics. Strong ex post discipline reflected by high litigation returns is more frequent the more influential the bidder during the last year before the freezeout. As we mentioned for the accept/reject decision, this evidence is consistent with the notion that the longer the bidder has held a dominant position in the firm, the more the court suspects that the majority may exploit the situation at the minority's expense by making the freezeout at an artificially low price. This interpretation is supported by our finding that the court only benchmarks its valuation on the stock price when the freezeout is fast. Hence, the court price is close to the stock price at the freezeout date, producing low returns from litigation in fast freezeouts. This evidence suggests that when the market for the firm's equity is well-functioning, the court considers the stock price a fair valuation of the minority stock. However, possibly because of the small sample size and the high diversity across verdicts, the statistical significance of the relationship between the court price and the freezeout speed is generally weak.

The court's ex post discipline is more pronounced for private firms than for public firms. This finding supports the hypothesis that because private firms are less transparent and because their stock trades less frequently, the majority will be more tempted to exploit the situation by underpricing the offer. We also find that regardless of case characteristics, the majority is more sophisticated than for minority, who often do not present any quantitative valuations of their stock. A private firm and an unsophisticated minority may both reflect settings where minority stockholders have difficulty protecting their interests at the offer stage, and where the majority does not account for this situation when considering the potential outcome of a court case. On the other hand, the litigation premium tends to be higher the larger the case. This finding suggests that even though both the majority and the court may consider minority stockholder rights in general, the minority's ability to insist on these rights in court is greater the larger their aggregate claim.

Overall, this evidence on rejected offers shows that the court disciplines the majority ex post because the ex ante discipline (i.e. at the offer stage) is insufficient for most offers ending up in court. Nevertheless, litigation is not excessive. Finally, the court's ex post protection of the minority through a large valuation markup is strongest when the minority is particularly weak. This happens when the firm is private and, somewhat less consistently, when the firm has been controlled by the majority for a considerable period.

The existing literature uses data from the United States, where the courts do not value minority shares. Rather, the minority has a right to legal review of a privately negotiated freezeout process. This ex post monitoring by the court is supposed to ensure that the freezeout price does not unduly reflect any uneven power distribution between the parties. Because no court price exists in such a system, however, researchers have instead analyzed the overall freezeout surplus split. They do this by comparing the two parties' wealth increase at the offer announcement with their respective stakes in the jointly held firm.