CORPORATIONS LEGISLATION - SHARE BUY BACKS AND SECTION 129
SHARE REPURCHASE AND "GREENMAIL"

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Well I am glad to hear that the situation is so simple with respect to buy backs here in Australia!

The basic authority for corporations to repurchase shares in the United States is found in the relevant State's corporation law. In Delaware, for example, corporations are expressly empowered to purchase their own shares provided the purchase does not impair the corporation's capital. Similarly in New York, a corporation may, subject to restrictions contained in its certificate of incorporation, purchase its own shares out of surplus except if the corporation would be rendered insolvent by such purchase. There are, however, as I will discuss in a minute, ways in which these State law provisions can be modified by Charter amendments.

With respect to greenmail, let me first go through some of the elements of a repurchase. There is no requirement that repurchases be made pro rata from all shareholders nor is there a requirement that purchases take place on a securities exchange in the case of public companies. Federal securities laws also do not require that shares be repurchased pro rata from all shareholders.

Courts generally will not interfere with the decision of directors to purchase the corporation's stock unless misconduct or fraud is involved. Recently, however, questions have been raised as to the propriety of the corporation purchasing a large block of its own stock from a single shareholder at a premium to market as a means of avoiding a takeover or a proxy fight. This is generally referred to as "greenmail" and is characterised by the following elements.

First, an investor acquires more than 5% of the stock of a publicly traded company and files a Schedule 13D with the Securities and Exchange Commission in which he is required to state his intention vis-a-vis the target. Typically the investor will state that his intention is to make tender offer or to engage in a proxy fight for control of the target. The target then agrees to repurchase the investor's shares at a premium to market and it is not uncommon for the target to pay the

investor's expenses. Third, the investor agrees to a standstill - that is in consideration of the repurchase he agrees that he will not purchase or solicit proxies for a number of years. And finally, the greenmailer having been bought off and the target having averted the threat of a takeover, the price of the target's stock falls.

There has been a considerable amount of debate in the United States as to whether greenmail or this selective type repurchase at a premium is a good or a bad thing. Arguments can be made that greenmail invariably harms remaining shareholders by decreasing the value of their shares as contrasted with the average increase in value that follows an ordinary pro rata stock repurchase at market rather than at a premium.

Most State corporation laws contain provisions to the effect that the business and affairs of the corporation shall be managed by or under the direction of the board of directors. Courts have long interpreted this language to mean that a business decision made by a corporation's board will not be reviewed or scrutinised so long as the acts of the directors are performed in good faith, in the exercise of their best judgment, and for what they believe to be the best interests of shareholders. There is a presumption that directors act in good faith and in the best interests of the shareholders, and to the extent such presumption is not rebutted by a showing of fraud or bad faith or self interest, the courts will generally not substitute its judgment for the judgment of the directors.

The decision to repurchase stock will thus be tested by reference to this business judgment rule. And there is authority for the proposition that directors are not liable for having their corporation buy a block of its shares at a premium price to fend off a purchase by outsiders that they believe in good faith pose a threat to the corporation's continued existence, provided their belief is based on appropriate investigation and competent professional advice.

Two recent decisions, the *Unocal* decision and the *Paramount Time* decision, I think are instructive in this regard. *Unocal* involved what is referred to as "front end loader two tiered offer" by Mesa, the corporate vehicle for T. Boon Pickens. This two tiered offer is an offer whereby the bidder offers to acquire 51% for cash and the remaining 49% in a freeze out merger, in this case the junk bond. Unocal's response was a defensive self tender - that is it offered to repurchase the 49% not sought by Mesa in the cash offer. However, Unocal's offer was made to all stockholders except Mesa, which was by this time Unocal's largest stockholder. Mesa contended that because Mesa was excluded from the Unocal offer and because the Unocal directors were able to participate in it, Unocal and its board were required to prove the fairness of the Unocal offer to all shareholders, including Mesa, and it failed to discharge that burden of proof.

The Supreme Court of Delaware, however, noted that when addressing a pending takeover bid, a board had an obligation to determine whether the offer was in the best interests of the corporation and its shareholders. The court outlined a two-fold test that had to be satisfied to entitle the directors to the business judgment rule: (i) did the directors have reasonable grounds for the belief that there was a threat to the corporation; and (ii) was the directors' response to that threat reasonable? In the circumstances the court held that faced with what the directors believed in good faith was a grossly inadequate two-tiered coercive tender offer, coupled with the threat of greenmail, that the Unocal board had a clear duty to protect the corporate enterprise. And the selective share repurchase plan was a reasonable alternative in relation to the proposed threat.

The court warned, however, that a corporation does not have unbridled discretion to defeat any perceived threat by any draconian means available.

Recently the Delaware Supreme Court has also rendered a decision in February of this year involving the *Time Warner* merger which has re-confirmed the views expressed in the *Unocal* case. In mid-1988 Time's board of directors authorised discussions with Warner concerning the possibility of a combination. After long negotiation the merger agreement was reached in March of 1989 providing for a stock for stock transaction in which Time shares would be issued in exchange for Warner shares. And after Time had mailed its proxy statement Paramount announced an all cash offer to purchase 100% of Time's outstanding shares. Time's board rejected this all cash offer as inadequate and concluded that the proposed merger with Warner should proceed as planned. Paramount thereupon raised its offer, but this was once again rejected by Time. Paramount and certain of the Time shareholders attempted to enjoin the merger with Warner. The court denied the injunction and issued its opinion in February that Time's board had satisfied the Unocal test in that there were reasonable grounds for believing that a danger to corporate policy and effectiveness existed and that the defensive measures adopted by the board were reasonable in relation to the threat imposed.

Both of these cases make it clear that boards must give careful consideration to defensive measures. In *Unocal* the board met on a number of occasions, discussed the proposed self tender at great length, were given detailed presentations by investment bankers and counsel and similarly in the *Paramount Time* case the court emphasised the deliberate and careful steps the board had taken in the course of its negotiations with Warner and in evaluating the benefits to the company of a merger with Warner.

Briefly I'll mention a few other matters relating to greenmail. Greenmail is now a very unpopular thing. New York and five other States incorporated anti-greenmail provisions in the corporation laws which basically prohibit a company from purchasing more than 10% of its own shares from any shareholder for a price in excess

of market unless the selling shareholder has held his shares for more than two years or the board of directors and the holders of a majority of the company's outstanding shares approve the purchase. Probably more significantly there are tax disincentives of a considerable dimension to making greenmail payments. The corporation paying greenmail will receive no deduction for expenses or premiums paid to the greenmailer. In addition, pursuant to amendments made in 1987, a person who receives greenmail in redemption of shares, greenmail meaning basically a premium over market, is subject to a non-deductible 50% excise tax on any gain or income realised in connection with such a purchase - and that is in addition to his regular federal income tax on a capital gain.

Another method of dealing with greenmail is to include anti-greenmail provisions Charter. A fairly simply amendment would prohibit a company from repurchasing its outstanding stock at a premium without the approval of the holders of the majority of the company's outstanding shares excluding those shares owned by the interested shareholders unless the same repurchase terms are offered to all shareholders.

Finally I would note that the courts and the SEC have dealt with the propriety of greenmail payment in a couple of cases. In one situation a claim was brought by shareholders to recover a $325,000,000 payment made in 1984 by Walt Disney Company to Saul Steinberg. That action was subsequently settled out of court but it created quite a stir because the California Court of Appeals upheld a preliminary injunction against the purchase and imposed a trust on the profit from the transaction that Steinberg would have received. If they had subsequently proved that Steinberg had breached a fiduciary duty to Disney and its shareholders, the plaintiffs would have been entitled under California law to a constructive trust for the profits.

And finally the SEC has brought enforcement actions, at least in one case involving B.F. Goodrich in 1987 in which they sought injunctive relief for the failure to disclose a $41,000,000 greenmail payment to Carl Icahn. The SEC's jurisdiction however, only relates to disclosure and they have no power to prohibit greenmail payments.