1988

Drafting an Effective Greenmail Prohibition

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DRAFTING AN EFFECTIVE GREENMAIL PROHIBITION

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Hostile tender offers have become a recurrent political issue. In recent years Congress has held seemingly endless hearings on the subject, and by now the testimony has settled into a familiar dialogue. Potential acquirers cast themselves as the embodiment of Adam Smith's invisible hand—their activities energize the market for corporate control with the desirable result of improving the efficiency of corporate management. Management of potential targets, in turn, claim the role of Albert Chandler's visible hand—efficient managers who internalize a function previously carried out by an inefficient market.[1] Their argument is that because the market for corporate control systematically understates companies' intrinsic values, managers must displace the market to prevent underpriced acquisitions.

Although the terms of the debate are cast in the language of efficiency, as with most serious political issues, much of the real substance is distributional. Even those who genuinely believe that hostile takeovers improve allocative efficiency will concede that some groups still suffer in the process. Their point goes no further than the claim that, after netting out the gains (to, for example, target shareholders) and the losses (to, for example, laid-off middle management and local communities), hostile takeovers still yield a positive result. A substantial amount of the conflict in Congress, as well as within and between states, is over who reaps the gains and who bears the costs of takeovers, whatever their net social impact.[2]

Out of this political maelstrom, one element of virtual consensus has emerged: greenmail—target management paying a potential ac-

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* Professor of Law, Stanford University. The research for this essay was supported by a bequest from the Claire and Michael Brown Estate. I am grateful to Richard Buxbaum for helpful comments on an earlier draft.

1. A. Chandler, The Visible Hand: The Managerial Revolution in American Business (1977).

2. This suggests that efforts by states to restrict hostile takeovers reflect the fact that, in those states, the potential injury to domestic interests from hostile takeovers through plant closings, relocation of executive offices, the loss of jobs and the like, exceeds the potential gain to domestic shareholders and the overall positive impact on the state from improved economic efficiency resulting from an active market for corporate control. See R. Gilson, The Law and Finance of Corporate Acquisitions 1059–60 (1986); Romano, The Political Economy of Takeover Statutes, 73 Va. L. Rev. 111, 138–41 (1987). Then-Professor Lehn and Professor Jones provide some empirical support for this thesis. Their study shows that the location of target firms' headquarters was highly correlated with a Senator's introduction of federal antitakeover legislation. K. Lehn & J. Jones, The Legislative Politics of Hostile Corporate Takeovers 22 (Mar. 19, 1987) (paper presented at a Conference in Political Economy and Business, Washington University, St. Louis, Mo.)

quirer to go away by repurchasing his shares at a premium—is bad.[3] Given the terms of the political debate, it is not surprising that broad support has developed for prohibiting greenmail. It is the only aspect of the hostile takeover phenomenon that is seen as a threat by both sides of the debate. From the perspective of the protakeover forces, greenmail is just another, albeit more blatant, technique by which target management entrenches itself at the expense of target shareholders. Prohibiting the payment at least eliminates this form of en-

3. The consensus is not, however, complete. Some managers simply resist any reduction in the range of available defensive responses to hostile takeovers. Warranting more serious attention, however, are two types of progreenmail arguments—conceptual and empirical—advanced by academic advocates. The conceptual argument, best stated by Professors Schliefer and Vishny, is based on a model in which paying greenmail may serve as a credible signal to potential alternative bidders that an opportunity is available that warrants attention. From this perspective, attracting competitive bidding is desirable because it results in a higher price. In addition to the information content of the greenmail payment, the argument runs, the greenmail payment eliminates the initial bidder who, because of its existing low cost stake in the target, would be at a significant competitive advantage in any bidding contest. Rather than preventing the target's takeover, in this view eliminating the initial bidder by paying greenmail is necessary to cause a takeover to occur at a more favorable price. Schliefer & Vishny, Greenmail, White Knights, and Shareholders' Interest, 17 Rand J. Econ. 293 (1986).

The difficulty with this model is that it does not take into account the conflict of interest between management and shareholders. Even if greenmail can serve the purpose of attracting competitive bids, it still can be used by less loyal management as a defensive tactic. The upshot is that, unless we can devise a means to distinguish "good" from "bad" greenmail, the value of greenmail depends on its overall impact across all cases in which it is paid, a pooling equilibrium problem.

This is where the empirical argument comes in. The claim, made most directly by Professors Macey and McChesney, is that aggregating the results in all cases in which greenmail is paid yields a net increase in target shareholder wealth. They note that the drop in share value on the announcement of a greenmail payment does not offset all of the increase in share value on the announcement of the potential acquirer's initial investment. The net increase, they argue, shows that the overall impact of greenmail is positive. Macey & McChesney, A Theoretical Analysis of Corporate Greenmail, 95 Yale L.J. 13 (1985). For a discussion of the empirical studies on which the argument is based, see infra notes 23–26 and accompanying text.

I have responded to this argnment elsewhere by predicting that all of this gain will disappear if the company that paid greenmail is not subsequently taken over. R. Gilson, supra note 2, at 736–38 (1986). The next generation of empirical studies confirms this prediction. These studies show that, on a portfolio basis, the net gain that remains after a greenmail payment disappears in the absence of a subsequent successful bid (although some companies retain their gains). Mikkelson & Ruback, Targeted Share Repurchases and Common Stock Returns 29 (Sloan School of Management Working Paper No. 1707-86, Massachusetts Institute of Technology June 1986), and Bhagat & Jefferis, Why Good Managers Pay Greenmail: The Economics of Targeted Share Repurchases 51–53 (University of Utah Graduate School of Business Working Paper, Sept. 1986). Those firms that are rapidly taken over by other bidders may have benefited from paying greenmail, but this still must be balanced against those firms whose higher share price is completely dissipated, leaving the greenmail payment as a loss to shareholders. Thus, we are left where we started—without the ability generally to distinguish good greenmail from bad greenmail. In this setting, the best approach may be to prohibit greenmail, leaving to shareholders the power to authorize its payment in specific cases.

trenchment. From the perspective of the antitakeover forces, greenmailers are the worst example of exploitive, opportunistic players in the market for corporate control, threatening an acquisition that has no efficiency justification (and may impose significant costs) simply to garner short-term gains. Prohibiting the payment eliminates the incentive to engage in such exploitive activity in the first place. The unique overlap of interests means that both sides can agree on one aspect of takeover reform: greenmail should be prohibited.

My purpose here is not to debate that conclusion but to comment on the more prosaic yet nonetheless pressing problem of how to implement a prohibition on greenmail. Some states already have adopted legislative prohibitions,[4] and the takeover legislation now pending in Congress also would prohibit the practice.[5] Additionally, a significant number of corporations have not waited for legislative action, instead adopting charter amendments that prohibit the individual corporation from paying greenmail.[6] The problem is that the efforts to date to prohibit greenmail are seriously underinclusive because they misunderstand the problem. Indeed, I will make the stronger claim that, rather than prohibiting greenmail, existing and proposed prohibitions in fact serve to legalize greenmail by creating a safe harbor within which it safely can be paid.

Part I of this essay describes the necessary components of any greenmail prohibition, illustrates their relevance to the twin goals of

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4. See Ariz. Rev. Stat. Ann. § 10-1204 (Supp. 1987); Minn. Stat. Ann. § 302A.553, subdivision 3 (West 1987); Nev. Rev. Stat. Ann. ch. 463.512–.516 (Michie 1987); N.Y. Bus. Corp. Law § 513(e) (McKinney 1986); Wisc. Stat. Ann. § 180.725(5) (West 1987).

5. See S. 1323, 100th Cong., 1st Sess. § 8, 133 Cong. Rec. 7601–02 (1987) (Proxmire chief sponsor); H.R. 2172, 100th Cong., 1st Sess. § 5 (1987) (Dingell and Markey chief sponsors); see also S. 1324, 100th Cong., 1st Sess. § 10, 133 Cong. Rec. 7668–69 (1987) (Sanford sole sponsor).

Judicial doctrine has never posed a serious threat to greenmail. Provided a record was made, review of directors' action in authorizing the repurchase was reviewed under the deferential business judgment rule, with predictable results. See, e.g., Heine v. The Signal Companies, 1976–77 Fed. Sec. L. Rep. (CCH) ¶ 95,898 (S.D.N.Y. 1977); Cheff v. Mathes, 41 Del. Ch. 494, 508, 199 A.2d 548, 555 (1964). The move in Delaware toward an intermediate standard of review of defensive tactics, see R. Gilson, The Law and Finance of Corporate Acquisitions 110–21 (Supp. 1987), as yet seems not to have resulted in increased scrutiny of greenmail. See Polk v. Good, 507 A.2d 531, 536–37 (Del. 1986). Indeed, the Delaware Supreme Court's analysis in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (Del. 1985), explicitly relied on the fact that greenmail could be paid in concluding that reverse greenmail—a purchase from all shareholders except the potential acquirer—was also lawful.

The one flash of more stringent review is Heckmann v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985), where the court affirmed a preliminary injunction barring a greenmail payment by Disney to Saul Steinberg.

6. Between 1984 and February 1987, some 70 publicly traded corporations, including, for example, Alcoa, Anheuser-Busch, B.F. Goodrich, Mobil and NYNEX, amended their articles of incorporation to add a prohibition of greenmail. Jaenicke, Greenmail: Background Report B, Investor Responsibility Research Center, Corporate Goveruance Service B-12 (Feb. 1987).

preventing exploitation and management entrenchment, and emphasizes the critical role of the definition of a premium. Drawing on a substantial body of empirical research describing the impact on the price of a target company's stock of the announcement both of an initial investment by a potential acquirer and of the repurchase of that investor's stock, this part demonstrates that what has been the most common approach to defining a premium—prohibiting only greenmail payments that exceed market price at the time of repurchase—is likely to be ineffective and at best serves only as a price control. Part II then evaluates three alternative definitions of a greenmail premium that do not present this critical problem. It concludes that equating a premium with the existence of investor profit is problematic, that direct statistical measurement of a greenmail premium is feasible, and that a market-based measure that identifies greenmail by the market's response to a stock repurchase may be the most effective approach of all. Finally, Part III describes how a greenmail prohibition can overcome two general objections to a legislative prohibition: that it can always be avoided and that a legislative prohibition is inferior to a private ordering solution.

I. The Necessary Components of a Greenmail Prohibition: The Central Role of a Premium

The standard greenmail prohibition bars, without shareholder approval, the non-pro rata premium repurchase of a substantial amount of stock from a short-term holder.[7] Each component of the prohibition—non-pro rata, substantial amount, short term, and premium—is designed to distinguish transactions that present the risk of greenmail from repurchase transactions that either serve valid corporate purposes not involving control, or that, whether desirable from other perspectives, do not present the risk of greenmail [8]

7. An example is the New York statute, whose substantive terms read as follows:

> (e) No resident domestic corporation which is subject to the provisions of section nine hundred twelve of this chapter shall purchase or agree to purchase more than ten percent of the stock of the resident domestic corporation from a shareholder for more than the market value thereof unless such purchase or agreement to purchase is approved by the affirmative vote of the board of directors followed by the affirmative vote of the holders of a majority of all outstanding shares entitled to vote thereon at a meeting of shareholders unless the certificate of incorporation requires a greater percentage of the outstanding shares to approve.
>
> The provisions of this paragraph shall not apply when the resident domestic corporation offers to purchase shares from all holders of stock or for stock which the holder has been the beneficial owner of for more than two years.

N.Y. Bus. Corp. Act § 513(e) (McKinney 1986).

8. The shareholder approval requirement, by contrast, gives shareholders the option of authorizing what is explicitly a greenmail payment if they so elect.

A. *The Non-Pro Rata Component*

The explanation for limiting the prohibition to non-pro rata repurchases is inherent in the reasons for prohibiting greenmail in the first place. With respect to the exploitation concern, unless the opportunistic investor is favored over other shareholders, he has no special incentive to give up the threatened offer or to make the investment in the first place. To be sure, a potential acquirer who forces the target company to restructure to defeat his offer[9] may still stand to gain a great deal, and that may provide an incentive to make the initial investment. But a potential acquirer following this strategy can profit only if all other shareholders profit. As a result, there is little risk of the opportunistic, exploitive strategies that motivate the antitakeover forces' opposition to greenmail. With respect to the entrenchment concern of protakeover forces, pro rata repurchases cannot dissipate a sizeable toehold investment, because the participation of other shareholders in the repurchase would cause the potential acquirer to remain a substantial shareholder. Thus, a pro rata repurchase generally does not have the entrenchment effect that motivates the protakeover forces' support for a greenmail prohibition.[10]

Excluding pro rata repurchases from the repurchase prohibition also avoids imposing unintended restrictions on other corporate finance techniques that do not raise control issues. A pro rata repurchase has the same financial effect as a dividend, and there is no corporate governance reason for preferring one method of distributing corporate earnings to another.[11]

B. *The Substantial Amount of Stock and Short-Term Holder Components*

The substantial amount of stock and short-term holder components also operate to exclude from the prohibition transactions that do

9. See, e.g., Lederman & Goroff, Recapitalization Transactions, 14 Rev. Sec. & Commodities Reg. 241 (1986).

10. That is not to say that pro rata repurchases cannot have an entrenchment effect. If both the repurchase and management's prerepurchase holdings are large enough, a pro rata repurchase in which management chooses not to participate can increase management's stake to the point where they have effective voting control. See, e.g., Nathan & Sobel, Corporate Stock Repurchases in the Context of Unsolicited Takeover Bids, 35 Bus. Law. 1545 (1980). A dual class recapitalization effected by an exchange offer operates to entrench management in the same manner. See Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes, 73 Va. L. Rev. 807, 812–13 (1987).

This aspect of the entrenchment effect of target stock repurchases raises concerns over the standard governing defensive tactics generally, rather than undermining the political consensus favoring the prohibition of the particular form of entrenchment—eliminating a specific potential bidder—resulting from greenmail.

11. Indeed, most modern state corporation statutes approach the regulation of distributions by explicitly treating repurchases and dividends as functional equivalents. See, e.g., Cal. Corp. Code § 166 (West Supp. 1987); Model Business Corp. Act Ann. § 6.40 comment 1 (1987).

not pose the risk of greenmail. However, they are not equally responsive to the two concerns, entrenchment and exploitation, whose convergence explains the political consensus supporting the prohibition. Moreover, drafting definitions of these two components is much less straightforward than distinguishing pro rata from non-pro rata payments.

1. *Conceptual Analysis.* — Restricting the prohibition to repurchases of substantial amounts of stock[12] recognizes that, unless a substantial number of shares are held, exploitive behavior of the sort feared by the antitakeover forces is an unlikely strategy because the implicit threat is too weak and the potential gain from the transaction too small. Similarly, unless the repurchase is substantial, there is little risk of management entrenchment because control of the company is unlikely to be affected by an insubstantial repurchase.[13]

Like the non-pro rata requirement, the substantial amount limitation operates to exclude from the prohibition some repurchase transactions that serve traditional corporate purposes. For example, companies often undertake premium repurchases limited to holders of odd lots to reduce shareholder-related expenses, like distribution of proxy material and annual and quarterly reports, that are a function of the number of shareholders rather than the number of shares owned. Without a substantial amount limitation, the prohibition would include such repurchases because they are not pro rata. Similarly, in executing a repurchase program for general corporate purposes,[14] it may be

12. Existing state greenmail prohibitions are limited to repurchases involving holders of at least 5 to 10% of a corporation's outstanding shares. Ariz. Rev. Stat. Ann. § 10-1204A (Supp. 1987) (5% of shares); Minn. Stat. Ann. § 302A.553, subdivision 3 (West 1987) (5% of shares); N.Y. Bus. Corp. Law § 513(e) (McKinney 1986) (10% of shares); Wis. Stat. Ann. § 180.725 (West 1987) (3% of shares). The Nevada statute specifies no percentage as it merely authorizes administrative rulemaking regarding greenmail. Nev. Rev. Stat. Ann. ch. 463.512–.516 (Michie 1987). The proposed federal statutes generally have lower thresholds. See S. 1323, 100th Cong., 1st Sess. § 8, 133 Cong. Rec. 7601, 7602 (1987) (Proxmire: 3% of any class of securities); H.R. 2172, 100th Cong., 1st Sess. § 5 (1987) (Dingell-Markey: 3% of shares); see also S. 1324, 100th Cong., 1st Sess. § 10, 133 Cong. Rec. 7668, 7669 (1987) (Sanford: 2.5% of shares).

13. Form versus substance problems could be raised here. Suppose a potential acquirer owned 10% of the target company's outstanding stock. To avoid the substantial amount component of the prohibition, a greenmail transaction might be structured as a repurchase of only 1%, but at a premium of a size that would have been associated with repurchase of the entire block. In turn, the seller would either sign a standstill agreement or simultaneously sell the remainder of his stock in the market. For a consideration of the general problem of form versus substance—transactions carefully crafted to avoid violating the form of the prohibition while still transgressing its substance—in connection with efforts to prohibit greenmail, see infra notes 51–57 and accompanying text.

14. Typical explanations for such programs include acquiring shares so that acquisitions and stock option plans can be carried out without diluting existing shareholders, as well as the belief that the shares are underpriced so that they represent a good investment. Put differently, and more consistently with an informationally efficient stock mar-

cheaper to purchase blocks of stock from existing holders at a premium than to make market purchases or a pro rata offer.[15] So long as the amounts repurchased are not in the aggregate substantial, such repurchases fall outside the prohibition.

Limiting the repurchase prohibition only to short-term holders[16] also seeks to exclude transactions that do not pose the risk of greenmail. However, unlike the substantial amount limitation, this approach looks largely to the exploitation concern of the antitakeover forces and not to the entrenchment concern of the protakeover forces. To prevent exploitation, the short-term holder component imposes a holding period that must be satisfied before shares may be resold to the company at a premium. Here, as in other regulatory regimes where a holding period is imposed,[17] the need to hold an investment subject to market risk for a significant period of time reduces the likelihood that the investor has an exploitive motive in making the investment by increasing the costs of such a strategy.[18]

In contrast, the short-term holder component speaks far less directly and effectively to the management entrenchment aspect of the consensus supporting the prohibition of greenmail. From this perspective, buying off a long-term shareholder presents precisely the same entrenchment concern as buying off a short-term holder. There is no particular reason to believe that a long-term holder might not turn out

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ket, the repurchase credibly signals that management possesses favorable private information bearing on the value of the company's stock.

15. News leaks of the market purchases may drive up the price of the stock more than the premium to be paid or, indeed, because of blockage—the difficulty of disposing of a large amount of stock—a block of stock may be acquired with no premium at all. With respect to the alternative of pro rata offers, the cost advantage of block purchases is avoidance of the costs of compliance with SEC rules governing issuer repurchases. See 17 C.F.R. § 240.13e-1, -3 to -4, -100 to -101 (1987).

16. Existing state statutes regulate repurchases involving shares held from two to three years. See Ariz. Rev. Stat. Ann. § 10-1204A (Supp. 1987) (shares held under three years); Minn. Stat. Ann. § 302 A.553, subdivision 3 (West 1987) (six months); N.Y. Bus. Corp. Act § 513(e) (McKinney 1986) (two years); Wis. Stat. Ann. § 180.725(5) (West 1987) (two years). The Nevada statute merely authorizes administrative rulemaking, and hence specifies no holding period. Nev. Rev. Stat. Ann. ch. 463.512–.516 (Michie 1987). Proposed federal legislation generally is limited to shares held for shorter periods. See S. 1323, 100th Cong., 1st Sess. § 8, 133 Cong. Rec. 7601–02 (1987) (Proxmire bill: six months); H.R. 2172, 100th Cong., 1st Sess., § 5 (1987) (Dingell-Markey: two years); see also S. 1324, 100th Cong., 1st Sess. § 10, 133 Cong. Rec. 7668–69 (1987) (Sanford: one year).

17. Both Rules 144 and 145 under the Securities Act of 1933 use the requirement of a holding period before resale of securities acquired, respectively, in a private offering and by certain persons in an acquisition as a basis for their exclusion from these rules' restrictions. See 17 C.F.R. § 230.144d-1 (1987) (seller of restricted securities held more than two years not regulated as an underwriter); 17 C.F.R. § 230.145d (1987) (seller of securities relating to acquisition, reclassification, merger or consolidation and held more than three years not an underwriter).

18. The preliminary note to SEC Rule 144 under the 1933 Act states this policy expressly. See 17 C.F.R. § 230.144 (1987).

to be a potential acquirer.[19]

Thus, a greenmail prohibition that was equally concerned with exploitation and entrenchment concerns would treat long- and short-term shareholders identically. The antiacquisition forces' concern about exploitation would justify restricting non-pro rata premium repurchases from short-term holders, and the proacquisition forces' concern about entrenchment would justify restricting non-pro rata premium repurchases from long-term holders. However, given that the political balance with respect to greenmail favors antitakeover forces, viable legislation is nonetheless likely to include a short-term holder component.

2. *Drafting Difficulties.* — There is a serious problem in reducing the concepts underlying the substantial amount and short-term holder components to operative language. The adjectives "substantial" and "short-term" lack precision; a party seeking to comply with a prohibition framed in those terms would confront siguificant uncertainty over whether a particular transaction was covered. For example, without more guidance the conceptual underpinnings of these components do not allow one to resolve with confidence whether a four percent repurchase involves a substantial amount of stock, or whether someone who has held stock for six months is a short-term holder.

Nor is there an easy way out of the problem. As a matter of administrative convenience, it is easy enough to specify a precise triggering percentage or minimum holding period. The problem is that any line chosen is necessarily arbitrary—it is difficult to imagine a reasoned distinction between repurchases of four percent and five percent or between six-month or seven-month holders. And precisely because any line would be arbitrary, the very drawing of one invites conduct that, although substantively of the sort intended to be prohibited, has been desigued to fall just on the other side.

This quandary reflects a general problem in regulatory drafting. The more specific a prohibition, the less likely it is unintentionally to deter socially desirable activity. Uncertainty whether a particular activity is covered by the prohibition deters that activity; specificity, because it reduces the uncertainty as to coverage, limits the unintended deterrence. The reduction in uncertainty, however, comes at a price. The more specific the prohibition, the more likely it is that undesirable behavior, intended to be prohibited, can be structured to fall outside the

19. To be sure, nongreenmail justifications can be offered for non-pro rata premium repurchases from long-term holders. But these reveal a control-related motive on their face. Thus, management may wish to prevent such large blocks of stock from possibly being acquired by raiders in a future takeover contest. This desire to keep the stock from falling into "the wrong hands" has an obvious entrenchment effect. Exploitation, by contrast, is not at issue, for management has no fear that the long-term shareholders themselves will engage in exploitive behavior.

prohibition.[20]

Resolution of this drafting dilemma would require balancing the amount and desirability of the conduct unintentionally deterred by too general a formulation against the amount and undesirability of the conduct unintentionally sanctioned by too specific a formulation. In the greenmail context, the relevant balance would compare, among other things, the amount of greenmail that a precise, relatively high specification of the substantial amount concept would allow to slip through with the justifiable repurchases for general corporate purposes that would be prevented (or made more expensive) if the substantial amount component was left more general (or made precise but low).[21]

One way around the underinclusive/overinclusive dilemma in the greenmail context would be to use the final component of the prohibition—that the repurchase be at a premium—to differentiate between desirable and undesirable transactions more precisely, but without the underinclusiveness that precision typically causes due to efforts to cast transactions so that they just avoid the precise boundaries set. Among other benefits, such a solution would take some of the pressure off the formulation of the substantial amount and short-term holder components. These components then could be drafted so that they swept broadly, relying on the precision of the final component to ameliorate any overinclusiveness. At the same time, the premium component is important in its own right because it focuses on the most critical element in both conceptions—exploitation and entrenchment—of the danger of greenmail: the potential acquirer's profit from the repurchase. Thus, the premium component has both derived and direct importance.

20. See Ehrlich & Posner, An Economic Analysis of Legal Rulemaking, 3 J. Legal Stud. 257 (1974). For an examination of this regulatory dilemma in a different corporate context, see Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 882–87 (1981).

21. The trade-off would be speculative on both sides. All that would be lost by an overinclusive formulation would be access to certain repurchase techniques—non-pro rata block purchases—that are claimed to be cheaper, for example, because not subject to the issuer tender offer rules under section 13(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78m (Supp. IV 1987), tban the alternatives, like a pro rata offer, that would remain available. I am not aware of any data that indicates the frequency of use or the cost differential in favor of tecbniques that would be foreclosed by an overinclusive formulation. Nor is there any way to tell how much greenmail would take place with an underinclusive formulation where the trigger amount was set precisely and at a high figure. Data concerning the size of past greenmail transactions that took place in an unregulated market would not indicate whether smaller transactions would take place once a prohibition of a specified size transaction was in place. So, for example, the fact that most siguificant greenmail purchases have involved more than 5% of the company's stock in fact may demonstrate only that a prohibition set at 5% will result in greenmail purchases of 4.9%.

C. *The Premium Component: The Core of the Prohibition*

The core of an antigreenmail prohibition is the requirement that the repurchase be at a premium. With respect to the fear of exploitation, unless a premium is paid, there is no incentive for an opportunistic investor to pursue a greenmail strategy in the first place. With respect to the fear of entrenchment, unless a premium is paid, there is little incentive for a potential acquirer to abandon an otherwise intended hostile offer, and therefore little risk that the repurchase will entrench management. As a result, the premium definition has the potential to take the pressure off the formulation of the substantial amount and short-term holder components. Any overinclusiveness of the formulation of these components may be mitigated by the additional requirement that a premium be paid. Moreover, the presence or absence of a premium contemplates a dichotomy rather than the continuum of the substantiality and short-term components. This component thus holds out the promise of precision that is neither under nor overinclusive.

This happy result depends, of course, on how the term "premium" is defined. The most common formulation of a greenmail prohibition takes the straightforward but, in the end, naive view that a repurchase at a premium is one at a price above the prevailing market price for the stock at the time of the repurchase.[22] This market-price measure of a premium has the advantage of being both precise and readily determinable. It reflects, however, a misunderstanding of the economics of the greenmail process and, as a result, is seriously underinclusive. Because the market price at the time of the repurchase already incorporates a premium for the greenmailer, a market-price measure of the existence of a premium does no more than set a ceiling—a form of price control—on the amount of greenmail that can be paid. Within this safe harbor, greenmail, in effect, is legalized.

To see this requires review of the empirical evidence concerning the impact on the price of a company's stock when a potential acquirer announces that it has made a significant investment in the company and, subsequently, when the company announces that it has purchased that investment. All existing studies display a consistent pattern. On the announcement of the investment, the stock's price increases significantly,[23] and the increase is particularly pronounced when the an-

22. The New York statute takes this approach, N.Y. Bus. Corp. Law § 513(e) (McKinney 1986), as does the Dingell-Markey House bill, H.R. 2172, 100th Cong., 1st Sess. § 5 (1987).

23. Holderness & Sheehan, Raiders or Saviors? The Evidence on Six Controversial Investors, 14 J. Fin. Econ. 555, 563 (1985); Mikkelson & Ruback, Corporate Investments in Common Stock (Sloan School of Management Working Paper No. 1633-85, Massachusetts Institute of Technology, Feb. 1985). Technically, the studies show positive abnormal returns, not simple price changes. For an explanation of the difference, see infra note 39.

nouncement states that the potential acquirer is considering additional purchases of the company's stock.[24] Empirical studies also uniformly show that the price of the company's stock decreases sharply following the announcement that the company has purchased the potential acquirer's stock,[25] and that the entire original increase is lost if the company is not subsequently the subject of a successful takeover.[26]

For our purposes, the critical point is that the market price of the company's stock on the date of the repurchase has already increased because, as a result of announcement of the initial investment, the market anticipates that a takeover may take place. Payment to the potential acquirer of that increased market price reflects precisely the premium that defines greenmail, a fact strikingly demonstrated by the drop in stock price that follows announcement of the repurchase.

The current crop of proposed federal greenmail prohibitions[27] do seem to recognize a part of the problem, but the solutions adopted are inadequate. Attempting to pick up some of the price increase that follows announcement of the initial investment, these proposals define the premium component of the prohibition as a price above market price, but then define market price as the average price of the company's stock over the thirty days prior to the repurchase.[28] As the time between the announcement of the initial investment and the repurchase increases, however, the averaging formula recaptures less and less of the premium implicit in the post-announcement price. For example, if the repurchase occurs fifteen days after the announcement of the initial investment, then half of the days counted in the average include a post-announcement premium. At the limit, if the repurchase takes place more than thirty days after announcement of the initial investment, so that the market price of the company's stock has reflected the increase in price from the announcement over the entire thirty-day period, the averaging formula will have no impact at all.[29]

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24. Mikkelson & Ruback, supra note 23, at Table 4.

25. Office of the Chief Economist, Securities and Exchange Commission, The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices 9 (Sept. 11, 1984); Bradley & Wakeman, The Wealth Effects of Targeted Share Repurchases, 11 J. Fin. Econ. 301, 308 (1983); Dann & DeAngelo, Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control, 11 J. Fin. Econ. 275, 294 (1983); Holderness & Sheehan, supra note 23; Mikkelson & Ruback, supra note 23.

26. Bhagat & Jefferis, supra note 3, at 45; Mikkelson & Ruback, supra note 3, at 29.

27. See S. 1323, 100th Cong., 1st Sess. § 8, 133 Cong. Rec. 7601-02 (1987) (Proxmire chief sponsor); H.R. 2172, 100th Cong., 1st Sess. § 5 (1987) (Dingell and Markey chief sponsors); see also S. 1324, 100th Cong., 1st Sess. § 10, 133 Cong. Rec. 7668-69 (1987) (Sanford sole sponsor).

28. The Arizona and Minnesota statutes also use a thirty-day averaging approach to determine market price. Ariz. Rev. Stat. Ann. § 10-1204B (Supp. 1987); Minn. Stat. Ann. § 302A.553, subdivision 3 (West 1987).

29. This result is even more pronounced when the potential acquirer actually has made a tender offer for the company's stock. Then the market price of the stock will have increased to reflect not just the increased probability that an offer will be made, but

Thus, while a precise definition of a greenmail premium is both important in itself and relieves pressure on the inherently imprecise substantial amount and short-term holder components, a market-price measure of this premium is inadequate. The market price at the time of repurchase already incorporates a premium, so this measure is itself seriously underinclusive. What is needed is a definition of a premium that takes into account the stock price rise that results from the announcement of the potential acquirer's initial investment.

II. Three Approaches to Defining a Premium

Three different solutions to the problem of a post-announcement price increase are possible: the use of investor profit as a proxy for the existence of premium; a direct statistical measure of the existence and size of a premium that accounts for the announcement effect; and an end run around the problem by using a measure that, in effect, allows the market to determine whether a premium was paid.

A. *A Profit-Based Definition of a Premium*

The problem with the standard market-price definition of a premium is that it is underinclusive—the premium implicit in the market price is ignored. One solution to the underinclusiveness problem uses the presence of investor profits as a proxy for the payment of a premium. By analogy to Section 16(b) of the Securities Exchange Act of 1934,[30] which uses trading profit as a proxy for a different form of illicit gain (from trading on inside information), this approach defines a premium as any price in excess of what the otherwise covered investor—one who is selling a substantial amount of stock not held for the requisite period—paid for the stock to be repurchased.[31] Thus, if a potential

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also the terms of the offer on the table. The Proxmire bill copes with this problem by specifying that when the person from whom the repurchase is made has commenced a tender offer or announced an intention to seek control of the company, market price is measured over the thirty trading days preceding the commencement of the offer or the announcement of the intent. S. 1323, 100th Cong., 1st Sess. § 8h(1), 133 Cong. Rec. 7601–02 (1987); see also S. 1324, 100th Cong., 1st Sess. § 10, 133 Cong. Rec. 7668–69 (1987) (Sanford bill with similar provision). Dingell-Markey does not deal with this problem. H.R. 2172, 100th Cong., 1st Sess. § 10 (1987).

An unsystematic review of a number of corporate charter prohibitions suggests that a simple market price measure of the existence of a premium, as found in Dingell-Markey, is the most common approach taken by voluntary efforts to prohibit greenmail.

30. 15 U.S.C. § 78p(b) (1981). Under section 16(b), all profits earned by an officer, director or 10% shareholder from the purchase and sale of an issuer's equity securities within a six-month period are recoverable by the issuer.

31. For an example of this approach in a charter amendment prohibition, see Proxy Statement of The Perkin-Elmer Corporation 18 (Oct. 12, 1984). Mobil Corporation took the point one step further by eliminating the premium requirement entirely. Proxy Statement of The Mobil Corporation A-7 (Feb. 22, 1985).

Congress recently took this approach in the Revenue Act of 1987, Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, tit. X, § 10228, adding section 5881 to acquirer buys a substantial amount of stock at ten dollars per share, and the company repurchases it shortly thereafter on a non-pro rata basis for fifteen dollars, the five dollar profit is treated as an illegal premium.

A profit-based definition of a premium has two advantages. First, it clearly remedies the underinclusiveness problem of a simple market-price definition; in most situations, a premium will result in a profit, and there is little risk that transactions intended to be prohibited will slip through the cracks.[32] Second, a profit-based approach has the advantage of ease of application. A bright-line, readily observable rule makes it easy to know in advance when a repurchase would be prohibited.

Like most bright-line prophylactic rules, however, the avoidance of underinclusiveness (and the ease of application) comes at the cost of potential overinclusiveness—some transactions may be covered that do not pose the twin risks of exploitation and entrenchment that motivate prohibiting greenmail. For example, if the price of a company's stock has been rising, a profit-based definition of a premium would prohibit purchases made as part of a general repurchase program from holders who have held too much stock for too short a time—for example, institutional investors—otherwise to be excluded from the prohibition by the substantial amount or short-term holder components.

To be sure, this overinclusiveness could be mitigated by tightening the terms of the other components of the prohibition:[33] by decreasing the holding period or increasing the size of the triggering amount. But solving the overinclusiveness of a profit-based definition by altering the coverage of the other components eliminates one of the factors that make the premium component so important to the drafting exercise. Recall that one of the hopes for the premium component is that its expected precision will relieve the pressure on the definitions of the

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the Internal Revenue Code. Section 5881 imposes a 50% tax on the profit realized from the receipt of greenmail, defined as consideration transferred by a corporation to acquire its stock from any shareholder who has held the stock less than 2 years and who has made or threatened to make a tender offer for the stock of the corporation, unless the acquisition is pursuant to an offer made on the same terms to all shareholders.

32. Some underinclusiveness nonetheless remains. One situation that a profit-based definition would not cover is that in which the price of the stock has declined and the premium—the amount above market price—does not exceed the decline. This problem is solved by the direct statistical measure of a premium considered infra notes 35-41 and accompanying text. For example, consider stock purchased initially at $10 per share, whose market price declines to $5 per share, and which is repurchased on a non-pro rata basis at $8 per share. The $3 premium is not captured, because no profit was made on the original stock purchase—in fact, a $2 loss occurred.

33. Section 16(b), which by its terms applies to all insider equity transactions completed within six months, has even more obvious overinclusiveness problems. These have been mitigated by Securities and Exchange Commission regulations, see 17 C.F.R. 240.16b (1987), and by judicial decision, see, e.g., Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 594 (1973) (section 16b directed only at transactions that could not serve as vehicles for trading on inside information).

substantial amount and holding period requirements that result from their necessarily arbitrary (and therefore unavoidably under or overinclusive) nature. It is hardly a step forward, then, to turn to these components as a means of solving the overinclusiveness of a profit-based measure of the premium component.[34]

B. *A Direct Statistical Definition of a Premium*

The lesson of the underinclusiveness problem with a market-price definition of a premium is that, to account for the announcement effect of the initial investment, the proper measure of a premium is the difference between the market price of the company's stock immediately *prior* to disclosure of the potential acquirer's initial acquisition and the repurchase price.[35] Lest this approach seem too easy, however, there are

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34. A profit-based definition can also be underinclusive. In the Revenue Act of 1987, Pub. L. No. 100-203, tit. X, § 10228, Congress seems to have attempted to mitigate the overinclusiveness problem by limiting the application of the section to shareholders who have "made or threatened to make a public tender offer for stock of [the repurchasing] corporation." The difficulty is that Congress badly overshot the mark, ending up with a significantly underinclusive definition. Most important, a would-be greenmailer need hardly make an explicit offer or threat to make an offer in order to get the point across. At the extreme, if an individual with a reputation as a raider—for example, Boone Pickens or Carl Icahn—announces no more than that he has acquired 10% of a company's stock for investment (although he is also considering other alternatives, including but not limited to acquiring control), no offer has been made or threatened, but the message that the company may be in play nonetheless has been delivered. Limiting the section's application to settings in which an offer has been explicitly made or threatened thus leaves the section's definition of greenmail quite underinclusive.

Adding, but less significantly, to the section's underinclusiveness, is its limitation to situations when a *tender offer* has been made or threatened. The threat that lends credence to an exploitive greenmailer is that to incumbent management's control. But the particular means by which that control is threatened is not important. Thus, there seems to be little reason to exclude from the ambit of the section shareholders who, for example, wage or threaten to wage a proxy fight.

A final point concerning section 5881 is the wisdom of dealing with issues of corporate governance through the mechanism of the federal income tax. Here the issue is not only the subterfuge of treating the matter as one of revenue, but the unfortunate quality of the work product when the lead drafting committee is without experience in matters of corporate governance.

35. But see SEC v. Carter Hawley Hale Stores, Inc., 760 F.2d 945 (9th Cir. 1985), in which the court rejected a similar statistical approach to determining the existence of a premium advanced by the Securities and Exchange Commission. In that case, however, the inquiry into the existence of a premium took place in a very different context. The court in *Carter Hawley Hale* held that for purposes of determining whether a corporate stock repurchase was an issuer tender offer under section 13(e)(1) of the Williams Act, the presence of a premium was determined by reference to a simple market price measure—the repurchase price less the market price immediately prior to disclosure. Id. at 951. The court's conclusion in *Carter Hawley Hale*, however, was influenced by the particular regulatory structure governing issuer tender offers. The terms of Rule 13e-1 contemplate that some issuer repurchases are not tender offers. A statistical approach to determining the existence of a premium likely would result in all issuer repurchases

two problems in using the predisclosure price as the basis for determining whether the repurchase price includes a premium, one that may require retrospective and the other prospective adjustment of the pre-disclosure price. It may be necessary, in calculating the premium, to adjust the market price that existed immediately prior to disclosure of the initial investment to account for the possibility of leakage—in case information concerning the initial investment influenced market price prior to its formal disclosure. In turn, it also may be necessary to adjust the pre-disclosure price to account for post-disclosure movements in the price of the company's stock due to changes in market conditions.

1. *Retrospective Adjustments in the Predisclosure Price.* — Determining the price of the company's stock immediately prior to disclosure of the potential acquirer's initial investment should not be difficult when the disclosure is required under section 13(d) of the Securities Exchange Act of 1934 and when there has been no leakage of the information prior to the filing of the 13D Statement.[36] But when formal disclosure under section 13(d) is not required because the initial investment is of less than five percent of the company's stock, there may not be a precise announcement date with reference to which the predisclosure price can be set. Indeed, even when a 13D Statement is filed, leakage may make it difficult to specify the actual predisclosure price[37] without examining price movements in the company's stock in the days preceding the formal announcement to determine the market price before it was influenced by information concerning the initial investor's activities.[38]

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occurring during a control contest being treated as issuer tender offers, a result arguably inconsistent with the regulatory pattern.

36. Section 13(d) of the Williams Act, 15 U.S.C. 78m(d) (1982), and Rule 13d-1, 17 C.F.R. § 240.13d-1 (1987), require that schedule 13D, disclosing, inter alia, the identity of the acquirer, the source of its funds, and the purpose of the transaction, be filed within 10 days after a person has acquired the beneficial ownership of more than five percent of any class of equity security registered under section 12 of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l* (1982). See, e.g., R. Gilson, supra note 2, at 936–47. The Proxmire and Sanford bills would reduce the five percent threshold to three percent and two and one-half percent respectively, and would require filings within one and two days after the initial investment. See S. 1323, 100th Cong., 1st Sess. § 3a, 133 Cong. Rec. 7601 (1987); S. 1324, 100th Cong., 1st Sess., § 3a, 133 Cong. Rec. 7668 (1987). If enacted, these provisions would reduce, though not eliminate, the problems associated with wholly undisclosed initial investments and with leakage.

37. In a related setting, the problem of leakage is significant. A recent study by the SEC documents that the combination of market speculation and possible insider trading results in significant price and volume increases in target company stock at least 10 days prior to the formal announcement of a tender offer. Office of the Chief Economist, Securities and Exchange Commission, Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation? 3 (Feb. 24, 1987). While the problem should be much less siguificant when what is involved is only an initial investment rather than a tender offer, it still must be kept in mind.

38. A standard approach would be to test for abnormal returns in this period. See infra note 39.

2. *Prospective Adjustments in the Predisclosure Price.* — After determining the predisclosure market price, the next step is comparing it to the repurchase price to determine whether a premium was paid. Once again, however, there is a danger of both over and underinclusiveness. The overinclusiveness problem arises when the company's stock price increases between the announcement of the initial investment and the repurchase in response to general market movements. A repurchase price that exceeds the predisclosure price only as a result of general market movements does not include the implicit premium that posed the problem with the simple market-price measure of a premium. Thus, the predisclosure price must be adjusted upwards to reflect postdisclosure general market movements before comparing it to the repurchase price.

Conversely, the underinclusiveness problem arises when the target company's stock price decreases between the announcement and the repurchase in response to general market movements. Though the repurchase price is absolutely lower than the predisclosure price, an implicit premium still will be present if the predisclosure price, now reduced to account for postdisclosure general market movements, is lower than the repurchase price.

Thus, adjusting the predisclosure price of the company's stock before comparing it to the repurchase price requires the ability to distinguish between price changes due to the investor's intial acquisition and price changes due to general market movements. Although in times of stable prices the task is likely to be straightforward enough, simple visual inspection of price patterns will not suffice in more complex periods when changes in general economic conditions have also affected stock prices. In these situations, however, developments in the statistical methodology used by financial economists now provide a powerful means to distinguish between stock price changes due to new information concerning the stock, like a potential acquirer's initial investment, and changes that result from general market movements.[39]

A direct statistical approach to measuring a premium thus has the

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39. Investigations making use of this methodology are commonly referred to as abnormal return (or prediction error) studies. Briefly, such a study uses either the capital asset pricing model or the market model to predict what a stock's price would have been, taking into account only changes in general economic conditions. When the stock does better or worse than predicted, the difference is referred to as a positive or negative abnormal return (or prediction error). When such an abnormal return is found to coincide with an unanticipated event, like the announcement of a potential acquirer's initial investment or the repurchase of that investment, it is possible to infer a causal relationship between the event and the abnormal return. Note in this regard that an abnormal return is *not* a measure of whether the stock price went up or down. Rather, it is a statement of whether the stock went up or down more or less than it should have. Thus, for example, a stock that goes down less than it should have, given the general movement in the market, has experienced *positive* abnormal returns even though the stock experienced an absolute price *decrease*. Similarly, a stock that moves up less than it

promise to satisfy the tasks assigned to the measurement of a premium in a greenmail prohibition.[40] It offers sufficient precision so as not to be predictably under or overinclusive itself. As a result, it can serve to relieve the pressure on the formulation of the substantial amount and short-term holder components. The costs of their inherent imprecision are significantly mitigated by the precision of the premium measure.

The statistical approach is not without drawbacks. First, like any statistical measure, it is not perfect; there is a margin for error.[41] Second, it requires a small econometric study, a benefit to economic consultants but a transaction cost for the rest of us. Still, if the need for econometrics is the transaction cost of precision, legal bickering over under and overinclusiveness (and the beneficial conduct inadvertently deterred or detrimental conduct inadvertently sanctioned) are the transaction costs of imprecision. The direct statistical approach, therefore, appears to offer real advantages over existing definitions of a greenmail premium.

C. *A Postrepurchase Measure of a Premium*

A third approach to measuring the presence of a premium seeks to provide the precision offered by the direct statistical approach, but without the econometric cost. It finesses the underinclusiveness/overinclusiveness dilemma by, in effect, harnassing the market to define greenmail. Recall that the difficulty in defining a premium results from the fact that the market price of the stock repurchased in a greenmail transaction has a built-in greenmail premium. The first two approaches responded by looking back to price levels before disclosure of the repurchase, the profit measure by using the potential acquirer's cost as a proxy for the predisclosure price and the statistical approach by retroactively adjusting the market price at the time of disclosure to reflect the impact of the initial investment. In contrast, the third approach looks to the market price *after* the repurchase: repurchases are prohibited at a price above the market price of the stock a specified

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should have, given the general movement in the market, has experienced *negative* abnormal returns even though it has experienced an absolute price *increase*.

For discussions of the use of abnormal return methodology in connection with problems similar to measuring a greenmail premium, see, e.g., R. Gilson, supra note 2, at 213–38 (1976); Schwert, Using Financial Data to Measure Effects of Regulation, 24 J.L. & Econ. 121 (1981).

40. This approach has been recommended by the Reporters of the American Law Institute's Corporate Governance Project. See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 6.04 and Comment c(2)(b) (Advisory Group Draft No. 9, Sept. 16, 1987). This recommendation has not been considered by the Council or membership of the American Law Institute, and therefore does not represent the position of the Institute. I am one of the Reporters. The views I express here, of course, are my own.

41. For a discussion of the interpretive problems in connection with abnormal return studies, see R. Gilson, supra note 2, at 235–38.

period—say three days—after public announcement of the intended repurchase transaction.[42]

To see how a postrepurchase measure of a premium distinguishes greenmail from legitimate repurchase transactions, consider two bodies of empirical data. First, as already noted,[43] a company's stock price typically drops immediately on announcement of a repurchase from a potential acquirer to reflect the reduced likelihood of a takeover. Thus, by setting as a ceiling on the repurchase price the lower market price existing after the announcement of repurchase, it is possible to eliminate all the potential profit from a greenmail strategy. To be sure, the data show that all of the price increase associated with announcement of the potential acquirer's initial investment is not eliminated by the announcement of the repurchase. What remains reflects the anticipation of another offer.[44] Although the target company still can pay the potential acquirer its proportionate share of this increase under a postrepurchase measure of a premium, the same gain is by definition available to any shareholder simply by selling in the market following the repurchase announcement. In contrast, parity in the prices available to the potential acquirer and other shareholders does not exist when, as with a simple market-price measure of a premium, the potential acquirer gets the pre-repurchase announcement price but other shareholders get only the lower postrepurchase price.

The second body of relevant empirical data concerns the price impact of nongreenmail repurchase transactions. We know that on average stock prices rise slightly following announcement of general repurchase programs that the market perceives as not involving greenmail.[45] The explanation offered for this price reaction is that by repurchasing shares, a company credibly signals that it has private information indicating that the market price is too low.[46] Thus, legiti-

42. To my knowledge, this approach was originally suggested by Joseph Grundfest. To date, it has not been reflected in any proposed federal legislation. At the state level, California recently almost adopted a greenmail prohibition that followed this tack, prohibiting repurchase of more than three percent of a company's stock not held for more than one year at a price in excess of the "post-disclosure market price," defined as either the market price of the stock three days after disclosure of the intent to make the repurchase, or the average price over the thirty days following disclosure. California Senate Bill 542 (Sen. McCorquodale sponsor, 1987). Although passed by both houses of the California Legislature, the bill was vetoed by Governor Deukmejian on September 19, 1987. For a criticism of the Governor's veto message, see Gilson, Odd Veto of Anti-Greenmail Measure, San Francisco Chron., Oct. 12, 1987, at C1, col. 1.

43. See supra notes 23–24 and accompanying text.

44. This is consistent with the idea that a benefit of greenmailers is to identify the opportunity for the rest of the market. See supra note 3.

45. See, e.g., Masulis, Stock Repurchase by Tender Offer: An Analysis of the Causes of Common Stock Price Changes, 35 J. Fin. 305, 316 (1980); Vermaelen, Common Stock Repurchases and Market Signalling: An Empirical Study, 9 J. Fin. Econ. 139, 179 (1981).

46. This explanation, in turn, suggests that the issuance of new stock should result

mate repurchase transactions would not be adversely affected by a post-repurchase measure of a premium because there would be no price drop as a result of the announcement of a nongreenmail repurchase.

The most intriguing part of this approach is that the solution relies on the market to identify greenmail. When the market believes that an announced repurchase involves greenmail, the stock price will drop to eliminate the greenmailer's built-in gain. When the market does not believe the repurchase involves greenmail, the stock price will not be adversely affected.

This reliance on a market determination of greenmail to eliminate a premium has a number of interesting advantages. First, the approach avoids the underinclusive/overinclusive dilemma because the market makes an individualized determination of whether a premium exists in every case. When it concludes that the market price prior to announcement of the intent to repurchase incorporated a premium based on anticipation that the potential acquirer would make an offer, the price drops to eliminate the premium. In this sense, the approach is less a rule, with a rule-like bias in favor of ease of application at the expense of an individualized determination in each case, than a standard where the focus is on the facts of the particular case.[47]

The second advantage flows from the first. Typically, an important part of the cost of the individualized inquiry associated with a standard is the cost of the inquiry itself. Because the rule/standard debate generally assumes that the decisionmaker will be a court, the open-ended flexibility of a standard imposes additional litigation expenses as compared to an easily (if not mechanically) applied rule.[48] Because a market determination of the existence of a premium and its resulting elimination if one is found is essentially self-executing, there are almost no administrative costs associated with this approach.

Finally, because both the determination of whether a premium exists and, if so, of the remedy in effect imposed, is precise, a market determination approach succeeds in taking the pressure off the formulation of the substantial amount and short-term holder components of the greenmail prohibition. The difficulty presented by both components is that if underinclusiveness is avoided by specifying a size of purchase trigger low enough, and holding period short enough, that no greenmail purchases will slip through, the net may also catch some

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in a comparable decline in the value of already outstanding stock because the sale signals that the company believes the presale stock price was too high. The data are consistent with this conclusion as well. See Ascquith & Mullins, Equity Issues and Offering Dilution, 15 J. Fin. Econ. 61, 65 (1986); Mikkelson & Partch, Valuation Effects of Security Offerings and the Issuance Process, 15 J. Fin. Econ. 31, 44 (1986); Scbipper & Smith, A Comparison of Equity Carve-Outs and Equity Offerings: Share Price Effects and Corporate Restructurings, 15 J. Fin. Econ. 153, 155 (1986).

47. See M. Kelman, A Guide to Critical Legal Studies 15-63 (1987).

48. The most familiar criticism of this advantage of a rule formulation in other contexts is that the ease of application is a myth. Id.

nongreenmail transactions that are not intended to be prohibited. The market determination approach solves this problem because even if the size of purchase or holding period requirements unintentionally cover a nongreenmail transaction in a particular case, the market determination of the existence of a premium nonetheless will effectively exempt the transaction from the prohibition. Because the market will recognize that the transaction is not greenmail, the stock price will not drop following announcement of the repurchase and the prohibition will have no effect on the terms of the transaction; the price three days later will not have been altered as a result of the announcement.

One might respond to this analysis by arguing that the post-repurchase measure of a premium is not costless to a seller inadvertently included in the broadened net of the nonpremium components of a prohibition that this approach allows. This approach does not distinguish between declines during the three-day postannouncement waiting period caused by general market movements and declines that occur in response to greenmailing; it would prohibit transactions in both cases. Hence, the seller must bear the risk that the market price will drop as a result of general market movements during the three-day postannouncement waiting period, and should that occur, that the transaction then could be completed only at the lower price. In fact, however, the parties could easily negotiate arrangements to reallocate this risk.

First, the seller could insist that its obligation to close the repurchase transaction be conditioned on the absence of a drop in stock price. Thus, there would be no risk that the seller would be forced to complete the sale at a different price than anticipated. That still would leave the risk that the transaction would go uncompleted, with both sides losing the benefit of their bargain, if the stock price dropped during the three-day post-transaction period because of general market movements. However, even this risk can be eliminated through the use of options on market indices, thereby leaving the seller hedged with respect to a stock price drop due to general market movements.[49]

49. There would be a cost to acquiring the options; however, it will always be a small fraction of the value of a transaction of the size that meets the substantial amount trigger.

It is also possible that the stock will drop during the three-day period because of new unfavorable firm-specific information. Where this information was known to the repurchasing company at the time of the repurchase agreement (that is, before the three-day post-announcement period), standard common-law and securities fraud remedies provide protection if the seller suffers damages as a result of not completing the transaction. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). The cost of the market determination approach that is more difficult to eliminate is the seller's loss of the benefit of his bargain when new company-specific information arises during the three-day period and the company had no prior knowledge of it, such as the unexpected loss of a major contract or customer. Even in these cases, however, one can imagine hedging strategies that may mitigate the problem. If there is an option market in the company's stock, the seller may hedge

Thus, examining the postrepurchase behavior of a company's share price appears to offer an accurate and inexpensive way to identify and prohibit the payment of greenmail premiums.[50]

III. Overcoming Objections to a Statutory Approach

The development of a number of solutions to the problems of drafting a workable greenmail prohibition does not exhaust the technical objections to proposed formulations, including the three discussed. One objection—that any prohibition can be avoided by clever lawyers and investment bankers—expresses skepticism that a prohibition can be effective regardless of how artfully drawn. A second objection—that some companies voluntarily have adopted prohibitions on greenmail while others have not demonstrates that no legislative action is called for—expresses a preference for a private ordering solution.

A. *The Clever Lawyer and Investment Banker Objection: Devising Greenmail Equivalents*

A familiar objection to proposals to prohibit greenmail is that clever lawyers or investment bankers will devise ways to accomplish the prohibited result—paying a potential acquirer a premium to go away—that will fall outside the boundaries of the prohibition regardless of how the prohibition is formulated. In other words, the objection is that any prohibition inevitably will be underinclusive. For example, Chesebrough-Pond recently repurchased Carl Icahn's five percent holding at market price, but augmented the implicit premium represented by this inflated market price by also purchasing an Icahn-owned company at a price regarded as substantially above its fair market value.[51] Indeed, the concept can be extended to eliminate the target company's repurchase entirely by recasting the transaction so that the potential acquirer sells his shares on the market simultaneously with the closing of the advantageously priced side transaction. One can even eliminate completely any sale of the potential acquirer's stock simply by coupling the favorable side transaction with a standstill agree-

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against price drops due to both general market movements and new company-specific information by purchasing a put option on the company's stock following disclosure of the repurchase (although if the repurchase is too large, this approach may still leave a "deductible" in the insurance provided by the purchase of puts). If there is not an option market, other hedging techniques may provide some protection against firm-specific events. For example, to the extent that any unfavorable company-specific information would affect the repurchasing company's competitive position, a hedging investment in the company's competitors may provide some protection.

50. In this setting, the information on which the market operates is widely distributed and of low cost. Thus, the market can be expected to reflect the information quickly and accurately. See Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 U. Va. L. Rev. 549 (1984).

51. See Jaenicke, supra note 6, at B-11.

ment.[52] If merely restructuring the form of the greenmail transaction serves to avoid the prohibition, the objection goes, the game simply is not worth the candle.

The problem posed by the clever lawyer and investment banker objection is endemic to business law. The boundaries of most regulatory systems are expressed by reference to transactional form: such regulation by its terms applies only to transactions that have a specified structure.[53] But the drawing of the regulation is only the first move in a multi-round strategic game.[54] The objects of the regulation then get the next move. And so long as the form of the transaction can be altered without siguificantly altering either the transaction's cash flow or the associated risk, a vast number of transactional permutations are available that maintain the substance of the transaction while causing its form to fall outside the boundaries of the regulation. In the game's next round, courts determine whether to respect the form in which the parties have cast their transaction or to draw upon a doctrine, like the de facto merger doctrine in corporate law[55] or the form versus substance and step transaction doctrines in tax law,[56] that looks past the formal terms of the transaction to its substance.

The same response is available to courts if confronted with efforts to create greenmail equivalents that fall outside the terms of the prohibition. The substance of a greenmail transaction is far less malleable than its form. To satisfy the requirements of both the potential acquirer and the target company, the transaction, whatever its form, must both provide the potential acquirer a premium and restrict his ability subsequently to mount a control contest. However many permutations in which the form of the transaction may be cast, these elements of substance cannot be altered without siguificantly changing what the

52. The standstill agreement, inter alia, would give the company a right of first refusal to purchase the shares, a prohibition on further acquisitions or other efforts to affect control of the company, and an obligation at least to vote the shares in the same proportion as all other shares are voted (or, more aggressively, as management directs). See, e.g., Bartlett & Andrews, The Standstill Agreement: Legal and Business Considerations Underlying a Corporate Peace Treaty, 62 B.U. L. Rev. 143 (1982); Note, The Standstill Agreement: A Case of Illegal Vote Selling and a Breach of Fiduciary Duty, 93 Yale L.J. 1093, 1094–95 (1984).

53. For example, both the Internal Revenue Code and many corporation statutes treat acquisitions that take the form of a statutory merger dramatically differently than an acquisition that takes the form of an asset acquisition, even though in substance they are virtually identical. See I.R.C. § 368(a)(1)(A) (1982) and I.R.C. § 368(a)(1)(C) (1982); Del. Code Ann. tit. 8, § 262 (1983).

54. This view of the regulation of business activities is developed in Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L.J. 239, 296–98 (1984).

55. See R. Gilson, supra note 2, at 533–80.

56. See, e.g., Chirelstein, Learned Hand's Contribution to the Law of Tax Avoidance, 77 Yale L.J. 440 (1968); Chirelstein & Lopata, Recent Developments in the Step-Transaction Doctrine, 60 Taxes 970 (1982).

transaction accomplishes. Indeed, because the substance of both the transaction and the prohibition is clear, the courts should have an easier time identifying greenmail equivalent transactions than they do in other areas where judicial doctrine has been developed to back up formally expressed regulatory systems.[57]

B. *The Private Ordering Objection: Companies Can Act of Their Own*

The second objection challenges the need for any legislation at all. Between January 1984 and February 1987, some seventy publicly traded companies voluntarily adopted greenmail prohibitions by charter amendment.[58] If companies are free to prohibit greenmail on their own, and if some companies do so while others do not, the implication is that a greenmail prohibition is not uniformly desirable. If that is the case, the objection goes, there is no justification for imposing a uniform legislative prohibition on all companies.

The proper response to this private ordering objection is not that legislation is preferable to private ordering, but that, in this context, legislation is necessary to facilitate private ordering. Recall that one of the two concerns supporting the consensus in favor of prohibiting greenmail is a fear of management entrenchment. To this, add the problem of management control of the agenda. As a general rule, the board of directors must approve any amendment to the company's articles of incorporation, including one prohibiting greenmail.[59] Thus, unless management offers them the opportunity, shareholders cannot prohibit greenmail. When one of the points of a greenmail prohibition is to prevent management from entrenching itself, one can have little confidence in the outcome of a private ordering process that gives management the power to veto a prohibition.

Put somewhat differently, the objection is driven by the fact that some companies have not voluntarily prohibited greenmail. But this outcome does not necessarily mean that a prohibition would not be desirable. The failure to prohibit greenmail is explainable either by management's good faith determination that a prohibition would not serve shareholder interests or by management's bad faith desire to retain this entrenchment tool.

In contrast to the limited role for shareholders in a purely private ordering process, legislation establishing a greenmail prohibition as the

57. For an application of this approach to other regulatory systems, see R. Gilson, supra note 2, at 533–80 (de facto merger doctrine); Gilson, Scholes & Wolfson, Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax Motivated Acquisitions, *in* Knights, Raiders and Targets: The Impact of Hostile Takeovers (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds., forthcoming Oxford University Press, 1988) (income taxation of acquisitions).

58. Jaenicke, supra note 6, at B-12.

59. See, e.g., Cal. Corp. Code § 905 (West 1977); Del. Code Ann. tit. 8 § 242 (1983); Revised Model Business Corp. Act § 10.03 (1984).

default rule serves to effectuate the goal of private ordering—allowing individual companies to vary the rule governing greenmail to meet their individual circumstances—by assuring that the outcome of private ordering actually reflects shareholder preferences. All formulations of a prohibition currently contemplate that greenmail can be paid if shareholders approve it. Thus, where management believes it desirable to repurchase the stock of a potential acquirer, the prohibition does not prevent the repurchase; it only requires shareholder approval. With this statutory structure, management's costless access to the company's proxy machinery facilitates putting the matter to the shareholders, and the requirement of shareholder approval acts as a check on the use of repurchases as a means of entrenchment.[60] So understood, a legislatively imposed greenmail prohibition is not inconsistent with a preference for private ordering. Rather, it functions to create a decisionmaking structure within the corporation that more effectively assures a private ordering role for shareholders.

Conclusion

In this essay, I have shown that the most familiar formulation of the prohibition on greenmail—focusing on repurchases above market price—serves not to prohibit greenmail, but to legalize it by creating a safe harbor within which it safely can be paid. I then surveyed three alternative formulations which solve this problem with differing levels of success. Identifying premiums by measuring sellers' profits is straightforward, yet has the potential to prohibit many legitimate stock purchases. Direct statistical measurements can distinguish greenmail premiums from price changes reflective of general market trends, though at the cost of introducing econometric modeling into regulatory enforcement. A still more promising approach is to identify greenmail as those repurchases that provoke declines in a stock's market price,

60. A different private-ordering issue is whether shareholders could elect to opt out of the statutory prohibition entirely should they believe that their company would be better off if management bad the discretion to pay greenmail witbout the need for specific sbareholder authorization for each repurcbase. The general issue of limits on shareholders' ability to adopt corporate governance rules that differ from the governing statute is beside the point because the analysis and result is precisely the same whether the issue is approving a particular repurcbase or opting out of the prohibition entirely. A private ordering solution is enhanced when, as put by the Reporters of the American Law Institute's Corporate Goveruance Project, "in corporate law the default rule should favor the party with less effective access to the proxy process." American Law Institute, Principles of Corporate Governance: Analysis and Recommendations 152 (Advisory Group Draft No. 8, Mar. 10, 1987). For a discussion of tbe issues posed in defining the boundaries of permissible opting out of rules specified in the corporate statute, see J. Coffee, Theories of the Corporation and the Problem of Remedies: What Role for Private Ordering? (Columbia University Law School Law & Econ. Working Paper No. 27, Apr. 1987).

recognizing the end of a prospective takeover. This allows for case-by-case evaluation by the market of the presence of greenmail.

Each of these approaches, moreover, would withstand attempts at evasion, for courts would have little trouble identifying the substance of a greenmail transaction. Finally, a statutory prohibition would enhance private ordering by ensuring that shareholders have the final say in all such transactions. Thus, properly drafted, a statute prohibiting greenmail can curb both exploitation and management entrenchment, meeting the concerns of both sides in the continuing debate over corporate takeovers.

More generally, the problem with the market price formulation results from the fact that its drafters did not understand the underlying financial economics of the transaction they sought to regulate. Over the last few years, a large body of empirical studies have been conducted on the operation of the market for corporate control and on the consequences of particular activities that affect control contests. This is an extraordinary change from the state of affairs ten years ago when lawyers debated the effects of different actions and alternative regulatory responses based only on what might be styled a lawyer's definition of data: the plural of anecdote. The lesson from this is straightforward. We cannot regulate—indeed, to avoid putting the cart before the horse, we cannot even determine whether regulation is appropriate—if we do not understand the underlying substance of the activity that concerns us.[61] Where that activity is part of the capital market, the task calls for the cooperation of lawyers and financial economists. Neither group is likely to do an acceptable job on its own.

61. This theme is developed in detail in Gilson, supra note 2.