GREEN MAIL TACTICS

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INTRODUCTION

Greenmail is the money paid by a company or allied company or individual to acquire its own shares of stock from a shareholder who is threatening to take control of, or unwanted influence over, the company. Greenmailing is a variation on the corporate raid or hostile takeover. The green mailer commonly targets a publicly traded company that is cash rich but often undervalued, with large assets and possibly a solid customer base. Other targets are companies that are simply inefficient. In any case, the green mailer seeks to avoid target companies that have implemented poison pills. The green mailer is not really interested in the business of the company. It doesn't want to own the company, improve it, or further build it up. It will, if forced to acquire the target, sell its parts off piecemeal, which can bring a greater profit than selling the whole target. This is called asset stripping and involves replacing management and firing employees. However, if a proper greenmail occurs, the green mailer merely secures a significant stake in the target company. The greenmailer can offer to end the threat to the target company by selling its share back at a substantial premium. The green mailer gets away with no oversight, low overhead, and its profits. The target is left poorer and without the assets that attracted the raid in the beginning.

Few issues in corporate law or governance have moved from the wings to the center stage of public attention as rapidly as the issue of negotiated stock repurchases, popularly known as 'greenmail.' The tactic was little used until recently. As the terms suggest, payment of 'greenmail' to 'raiders' has generally not met with approval. It has been called everything from 'extortion' and 'a disgrace to 'unfair, unjust, and wrong. Those who call for regulation of greenmail payments voice two principal objections to the practice. First, they say that greenmail must be controlled because, allegedly, it is inequitable to the shareholders who do not benefit from the payments. Second, critics claim that management pays greenmail in a self-serving attempt to prevent a shift in corporate control that would threaten their jobs. Here, management uses corporate assets to save its jobs when acquisition of a significant minority block by a third party augurs a bid for a change in corporate control that otherwise would benefit the shareholders.

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One of the most important debates of current corporate law practice and scholarship is about the appropriate role of target management confronted with a takeover bid. The controversy turns on the identification of a criterion for evaluating takeovers and target management defensive tactics. An influential body of opinion contends that maximization of shareholder wealth is the appropriate criterion because, first, traditional notions of fiduciary duty generally require managers to act in the shareholders' interest, and, second, shareholder wealth maximization is seen as the best available proxy for social wealth maximization. On this view, takeovers are desirable because they can increase shareholder wealth in two ways: first, by moving assets to managers who can produce the greatest economic return from them; and second, by increasing pressure on current management to maximize economic return from assets under their stewardship.

Management has only two justifiable options for responding to a takeover bid. Some argue that management should respond passively. Passivity will maximize shareholder wealth by increasing the returns to search for takeover targets, which raises the number of value-increasing bids. Others contend that management may abandon passivity, but only to the extent necessary to instigate an auction for the firm. An auction will ensure that the user who most highly values the target assets will gain control over them while maximizing the payoff to target shareholders. Which of these responses would in fact maximize shareholder wealth is a matter of dispute.

THE CASE FOR GREENMAILTACTICS

It is a form of stock buyback as a defense tactic to a hostile takeover where a targeted share re-purchases, or 'greenmail,' in which the target repurchases the shares held by the acquirer at an above-market price. To determine whether or not the tactic is a good defense or an extortion mechanism one has to lay down the criteria or standard on which it can be measured.[82]

Two criteria inform the legal approach to target stock buybacks.[83]

1. First, the law seeks to maximize shareholder wealth. To this end, legal rules should promote the transfer of assets from 'inefficient' managers to 'efficient' managers and should induce greater efficiency from current managers. By definition, an

82 Gordon & Kornhauser, 'Takeover Defense Tactics: A Comment on Two Models', 96 YALE L.J. 295 (1986).

83 'Greenmail: Targeted Stock Repurchases and the Management-Entrenchment Hypothesis', 98 HARV. L. REV. 1045 (1985)

efficient manager earns a higher return on each dollar of assets than an inefficient manager.

2. Second, the law seeks 'fair' management treatment of shareholders. 'Fair treatment' encourages shareholder investment and comports with traditional notions of fiduciary duty. In the context of target stock buybacks, fair treatment most plausibly means that management actions must not favor wealth acquisition by one group at the expense of another.

The minority shareholder will accept greenmail whenever its amount exceeds the expected gain from obtaining control. The incumbents will pay greenmail when its amount is less than the cost of litigation or any other means of dissuading the minority from obtaining control and also less than the expected additional gain from a second takeover bid.

Suppose that the target firm's stock trades at Rs 30 a share. This price reflects the market's expectations about future events, including takeovers. Assume that before M acquires her share the market perceives a 50 percent chance that the firm will be taken over at an average price of Rs 35 per share and a 50 percent chance that the firm will not be taken over at all. If the firm is not taken over, it remains in the control of its present management where the market would value it at only Rs 25 per share. The firm's current worth of Rs 30 per share is the sum of the expected values of the two events (Rs35 x .5 + 25 x .5 = 30).

Other types of takeover defenses involve the target taking some action that harms both target and bidder, although the broad category of takeover defenses is more commonly known as "shark repellents"[84] and includes the traditional shareholder rights plan poison pill. The target company issues rights to existing shareholders to acquire a large number of new securities, usually common stock or preferred stock. The new rights typically allow holders (other than a bidder) to convert the right into a large number of common shares if anyone acquires more than a set amount of the target's stock (typically 20-30%). This dilutes the percentage of the target owned by the bidder, and makes it more expensive to acquire control of the target. This form of poison pill is sometimes called a shareholder rights plan because it provides shareholders (other than the bidder) with rights to buy more stock in the event of a control acquisition.

If the higher price established by the shark repellent amendments lowers the takeover probability from 50 percent to 40 percent (and thus increases from 50 to 60 percent the

84 Available at <http://www.factset.com/websitefiles/PDFs/brochures/fsm115_sharkrepellent_brochure. pdf.> (Last visited on 25.04.09)

likelihood that less efficient current owners will continue in control), the market price of their shares would increase to 30.60 per share (39.00 x .4 + 25.00 x .6 = 30.60). In this case, shark repellents are advantageous to shareholders and would be adopted if they were the only defensive tactic available.[85] Shareholders, however, inevitably will search for an even better device to mitigate the effect of the prisoner's dilemma and buy time for another subsequent bid. That weapon often may be greenmail.

Suppose that, instead of shark repellents, the management of the target firm makes it known that it is willing to pay greenmail to M, if M will either refrain from obtaining more of its stock or sell what she has and agree not to acquire any more. Like a tender offer, a greenmail transaction informs the market that the target firm's stock is undervalued. Moreover, once M is bought out, other bidders have more time and thus a greater opportunity to formulate their bids. For both reasons-more information and more time-greenmail raises the probability of some bidder making an offer and of an auction developing that will increase the price of a successful tender.

Greenmail allows the firm to make unwanted suitors go away without discouraging them from producing information about the target firm in the first place. And, unlike other defensive tactics such as shark repellent amendments, greenmail does not discourage additional tender offertory from making offers, but rather encourages them. The ability to pay greenmail thus increases the probability of a takeover attempt occurring, while other defensive tactics lower it.[86]

Welfare Implication of Greenmail: [87]

When greenmail is paid, the target firm's resources go to the firm or individual who has conferred an informational benefit upon the shareholders. In this respect, the payment of greenmail differs from other sorts of defensive tactics. Like greenmail, other defensive tactics benefit target shareholders by permitting them to avoid an initial tender offer they think is too low. But unlike greenmail, these other tactics discourage initial offers by raising the cost of such offers. The potential for obtaining greenmail, by contrast, encourages rather than discourages bidders to invest resources in ferreting out information about target firms, even where that information may be of more value to a third party than to the initial offeror. The transfer of resources from lower- to higher-

85 Jonathan R. Macey and Fred S. McChesney, 'A Theoretical Analysis Of Corporate Greenmail', Yale Law Journal November, 1985

86 'A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers', 33 STAN. L. REV. 819, 860 (1981)

87 Supra note 85

valuing users not only raises firms' share prices, but also increases total wealth and so performs an important social function.

Consumption of Real Resources:[88]

There is another objection raised by critics to the use of defensive tactics in resisting takeover bids. The very process of resistance itself consumes real resources. The most obvious example is litigation, which consumes the time and talent of managers, legal staff, and judges and so on. The deadweight social costs can amount to millions of dollars. These losses are reflected in lower values that bidders will offer when resistance is expected. Greenmail is purely a transfer payment. There may be costs of bargaining over the exact terms between the firm and the greenmailer, but these are trivial compared to the costs of litigation or other defensive tactics.

Greenmail does not consume valuable resources.

THE CASE AGAINST GREENMAILTACTICS

The above argument shows greenmail payments to eliminate or fix the level of minority ownership can benefit minority and majority shareholders of the target firm as well as third-party tender offertory. Nevertheless, greenmail has been heavily criticized. The attacks on greenmail can be grouped into two categories.[89]

1. The charge that managements pay greenmail only to protect their jobs (the agency-cost objection).
2. The claim that negotiated repurchases treat majority shareholders inequitably, since shareholders do not share the greenmail premium equally (the unfairness objection).

To illustrate both these objections it is essential that one distinguishes between conscientious targets management from self-interested target management for the implication of a green mail agreement is different in both cases.[90]

- A conscientious management would either assesses the prospect of a third party's offer more favorably than the acquirer or believe that, in light of the acquirer's actions, management can increase the value of the firm.

88 *Ibid*

89 Kraakman, 'Corporate Liability Strategies and the Costs of Legal Controls', 93 YALE L.J. 857 (1984)

90 'Investment Bankers' Fairness Opinions in Corporate Control Transactions', 96 YALE L.J. 119, 121-24 (1986).

- In case of self-interested management, an agreement does not depend on management's having more favorable beliefs about the prospects of a third party bidder. Rather, greenmail may be paid if the value to management of retaining control of the target exceeds the value of the target to the bidder.

Management's valuation may be higher than the bidder's for two reasons.[91]

1. Management may simply be converting to its own use value that should go to the shareholders. With this motive, management will pay greenmail only if the acquirer has underestimated the extent of management inefficiency or self-dealing, so that even after the payment there remains convertible value for management.
2. Management may simply assign non-economic value to its control over the target by an amount that will exceed the bidder's valuation.

In either case, management must believe that the greenmail payment will forestall a subsequent takeover. If self-interested management believed that payment of greenmail would lead to a later acquisition by a third party, it would have no interest in paying greenmail.

1. Agency Cost Objection:

A substantial newly assembled minority block of shares may be the prelude to a tender offer or some other change in corporate control, putting the manager's future employment at risk. Rather than lose his job, the agency-cost hypothesis predicts that the manager will opportunistically exploit his control of corporate assets to remove the risk.[92]

Under the agency-cost hypothesis, management's ability to pay greenmail thus sacrifices shareholder assets for the sake of a manager's employment. In effect, the minority shareholder and the agent-manager collude to benefit themselves at the expense of the manager's principal, the majority shareholders. The consequences are both distributive and allocative. The loss to the majority is not confined to the assets paid over to the

91 Easterbrook & Fischel, 'Auctions and Sunk Costs in Tender Offers', 35 STAN. L. REV. 1 (1982);

92 A. Berle & G. Means, The Modern Corporation And Private Property 119-25 (1933) c.f http://international.westlaw.com/result/default.wl?method=TNC&fn=_top&rlt=CLID_QRYRLT9325152456 211&mt=126&rltdb=CLID_DB7656351456211&db=YLJ&fmqv=s&query=%22GREENMAIL%22+ HOSTILE+TAKEOVER&cfid=1&action=Search&vr=2.0&sv=Full&cnt=DOC&ifm=NotSet&origin=Search &rs=WLIN9.01& service=Search& effdate=1%2f1%2f0001+ 12%3a00%3a00+AM&srch=TRUE&rp=%2f Welcome %2f126% 2fdefault.wl&sp=intjod- 000&rlti =1&eq=Welcome%2f126. (Last visited on 30.04.09)

greenmail recipient. Were greenmail payments not possible, some minority holders would probably have bid for majority ownership, making a tender offer at a premium above market price. Greenmail payments 'reduce competition for corporate control. In addition to dissipating existing assets, therefore, greenmail also costs shareholders the expected value of foregone offers for control, and society the foregone opportunity of a transfer of resources to those who could have managed them better. The underlying basis of thesis is a twin assumption that either the management is unconscientious or incompetent.

Counter Argument:

If we look once more at the way greenmail payments differ from other defensive tactics, the hypothesis that greenmail is necessarily paid by incumbent management to preserve their jobs appears flawed. Firms have limited resources. Those that pay greenmail do not discourage subsequent raiders from making hostile bids. Rather, they *encourage* such bids by signaling to the market that the firm has been perceived as undervalued by an imminent tender offerer or that new profit-increasing information about the firm has been purchased. Management teams that pay greenmail succeed only in thwarting a bid for control by the specific firm or individual who actually receives the payment. The greenmail game, however, is one that any number can play. If management pays greenmail once in order to protect its jobs, it must be prepared to pay it again and again. The more greenmail a firm pays, the greater the diminution of its assets, and so the greater the drop in the price of its shares. This drop in share price alerts shareholders to management's pursuit of job tenure rather than firm profits, thereby increasing the likelihood of management being ousted. Moreover, this drop may facilitate takeover by yet another outsider, whose first act will be dismissal of the management that has dissipated firm assets so fruitlessly. Thus, even if one believes that agency costs are a formidable problem in large corporations, greenmail seems a self-defeating tactic for managers concerned about job tenure.

2. Unfairness Argument:[93]

A second objection to corporate greenmail payments concerns the way in which green mailers assemble their holdings. Accretion of a substantial minority block, the argument goes, may be sufficient to give the shareholder some de facto control over corporate affairs. Assembly of substantial minority holdings by open-market purchases can often be accomplished without attracting the attention of target firms. Once the 'raider' has

93 Supra note 92

quietly acquired her minority toe hold, she supposedly will identify herself and demand greenmail. Greenmail becomes, according to the unfairness argument, a premium for repurchase of control, which supposedly belongs to all shareholders.

A closely related argument against greenmail is the assertion that it violates the principle of corporate law that all shareholders of a particular class should be treated equally. Since shareholders have all paid the same price for their stock, they legitimately expect to be treated the same, and to do otherwise would be 'unfair.

Counter Argument:

The argument misperceives the nature of greenmail payments. The greenmailer is not 'equal' to other shareholders in the same class, as she alone has developed information beneficial to the firm. It is hardly unfair to pay her for that information-indeed; it would be unfair not to do so. Moreover, other shareholders benefit from the greenmail sequence anyway in the increase of the price of their shares, an increase less likely to occur if the green mailer is forced to share her gains.

POSSIBLITY OF GREENMAIL IN INDIA

The Securities Exchange Board of India, 1992 has a Takeover Code called Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997[94] which is a product of the Bhagwati Committee Report and overlooks the process to be followed when share acquisition in a company exceeds a certain minimum and the obligations and implications thereafter.

Current Legal Framework permits Green Mail:

Regulation 22 of the Code provides that the offer to acquire shares in a company beyond 20 percent is made public via a letter and such a letter is sent to all the shareholders of the public company. Further it is mandatory for the director of the acquiring company to take responsibility for the information. Regulation 23 allows for an agreement to sell, transfer, encumber or otherwise dispose of or enter into an agreement for sale, transfer, encumbrance or for disposal of assets otherwise, not being sale or disposal of assets in the ordinary course of business, of the company or its subsidiaries, issue any authorized but unissued securities carrying voting rights during the offer period; or enter into any material contracts provided it is with the approval of the shareholders.

94 Availabeat<http://www.sebi.gov.in/Index.jsp?contentDisp=SubSection&sec_id=5&sub_sec_id= 5> (Last visited on 01.06.09)

A green mail is essentially implemented through a greenmail agreement which involves buying back the shares from the acquirer at some premium. It is allowed for under regulation 23 as a sale not being in the ordinary course of business provided it is approved of by the shareholders. Alternatively it is done by the management of the firm who thinks the value of the firm is undermined. This option allows stalling time to invite better and higher offers for the company.

Regulation 25 permits a competitive bid which is an offer for acquisition of shares of the same target company by anyone other than the acquirer within 21 days of the offer of the acquirer being made public and 25(6) allows for upward revision of such offers. The only hitch in the current regulations hindering greenmail could possibly be the time constraint.

During all this the merchant banker is regulating the flow of information of such take over. The argument that one is paying greenmail for the information of the value of the firm that is exclusive then fails in the Indian context. With a market regulator like the SEBI and an environment of investor protection, information is no longer exclusive and much public.

Despite such a loose regulatory mechanism which though does not cover the issue of greenmail specifically, can easily fit it within its ambit; greenmail as a defense tactic is seldom used in India. The GESCO– AH Dalmia case is the closest India has come to a greenmail option.

A Case Study[95]

The culmination of one of the most vigorous corporate battles of recent times in India naturally calls for an identification of the winners and losers. The battle for the real estate - rich Mumbai company GESCO with a market price for its scrip that did not reflect either its book value or any other inherent strength, began on October 19 last with the AH Dalmia group of Delhi making a hostile bid for a 45 per cent stake at Rs. 27 a share.

This price was even less than half the book-value of the company (Rs. 54.50). Interestingly, the offer and the counter offer pushed up the bidding cost and in the end the predator, the AH Dalmia group sold out its 10.5 per cent stake at Rs. 54 per share for a consideration of Rs. 16.35 crores. That holding - consisting of 30 lakh GESCO shares

95 C. R. L. Narasimhan, Greenmail, winners and losers - the Gesco takeover battle, The Hindu, Wednesday, January 10, 2001

- was acquired earlier at an average cost of Rs. 24 per share (for a consideration of Rs. 7.20 crores). And after Sheths, the promoters of GESCO, brought in a friendly 'white knight' in the form of Mahindra Realty to help them stave off the threat from Renaissance, Mr. Dalmia opted out by selling his stake to the promoters for a cool 150 per cent profit.

The obvious winner therefore is the Dalmia group that pocketed a quick Rs. 8 crore and odd. Maybe that was not how the script should have read. The group seemed intent on taking full control of the company and thereafter exploits its rich real estate. In the end it turned out to be a transaction for swift profit and almost akin to a "greenmail". This term refers to an act of an investor who buys a large block of stock with the intention of selling it to a corporate raider at a premium or selling it back to the company at a higher premium to keep it out of the reach of the corporate raider. The Gesco affair comes as close as anything can in India to a greenmail.

Prior to this Arun Kumar Bajoria, a trader and jute mill owner from Kolkata announced his intention to mount a raid on the venerable old Bombay Dyeing company. Mr. Bajoria has already liquidated part of his stake in Bombay Dyeing and announced his intention of taking greenmail for the rest, if only he can get the right price.

Acceptability of Greenmail in the Indian Legal Jargon:

With the serious bid by A H Dalmia of Renaissance Estates to take over another realty firm, the GESCO Corporation the air was thick with talk of 'greenmail', 'white knights', 'poison pills' and 'leveraged buyouts' - jargon originally associated with the corporate battlefields of late-eighties America, but which has now gone into play in the newly liberalized Indian economy. Essentially the issue concerned 'hostile' takeover attempts: they were practically impossible in the old control regime overseen by the Company Law Board, but as the Bombay Dyeing and Gesco cases show, are now much easier under the new rule-based system governed by SEBI's takeover code. The Justice Bhagwati Committee which had formulated the code is now engaged in efforts to revise and fine tune it. Anxious questions have been raised as to whether hostile takeovers should be allowed at all - especially by persons who may not have the necessary skills or the motivation to run the company efficiently. Their purpose, if they succeed, may simply be to strip the company of its cash and other assets; and, if they cannot, to sell out their holdings at a huge profit and get out (the so-called greenmail option).[96]

96 Greenmail and White Knights, Times of India, 23rd January 2001

The threat of takeover is considered good for the small investors. The share prices of both companies shot up several times and many investors were able to exit at a high price. The companies too stand to benefit as the wake-up call to the managements leads them to increase and consolidate their shareholdings; studies clearly show that managements which have higher stakes in their companies perform better in terms of profitability and delivering shareholder value.

The outcome is clearly consistent with the philosophy behind the takeover code, which is to bring about a "market for corporate control", in which underperforming managements will have to make way for those which can ensure better returns for the public money deployed in their companies. This is only one mechanism, the ultimate sanction so to say, among many measures that are being introduced to ensure better governance in the corporate sector. The governance, also being instituted by SEBI, requires companies to have independent boards; institute audit committees; and move towards international accounting standards and disclosure norms. The Indian corporate sector is in a transition phase, from a regime of stifling government controls towards a rule-based market economy and conforming to global standards of performance and disclosure, all of which can only be to the good of the economy.

Skeletal Legal Framework Required:

The ideal legal rule would permit value-increasing greenmail payments and prohibit value-decreasing ones. Such a rule would be difficult, if not impossible, to formulate. Consider first a liability rule which would hold management responsible for losses to shareholders if the value of the firm did not increase after the payment of greenmail. Under this rule, management would rarely pay greenmail without express shareholder approval. Management, however, might often refuse to pay greenmail when shareholders would have desired the payment. The desirability of a greenmail payment depends upon an accurate assessment of the prospects of a better offer. A management facing prospective losses if the better offer does not appear would almost invariably reduce its risk by not paying greenmail. However, most greenmail cases are factual and unique and the possibility of chance is high. If chance elements predominate, then no legal rule is likely to identify *ex ante* desirable greenmail payments. For example, self-interested management may simply be wrong in its unfavorable assessment of the likelihood of a third party bid.

CONCLUSION

At a minimum, this conclusion argues in favor of applying the traditional business judgment rule to challenges of greenmail payments. Indeed, we would go further. Managerial motivation, a factor even in the business judgment rule, is a poor guide to policy. Successful corporations are not those where managers are unselfish, but those that couple managers' personal incentives with those of the firm.

The central question in evaluating the payment of greenmail should be whether the actions of managers, irrespective of motive, coincide with the best interests of the shareholders. The role of robust markets for corporate control and markets for managers is to facilitate the alignment of interests between managers and shareholders. Thus, the role of the courts in evaluating the payment of greenmail should be to determine whether such payments impede or enhance the welfare of shareholders, including their ability to benefit from the working of the market for corporate control. Only with persuasive empirical evidence should stricter scrutiny replace the traditional deference accorded managerial decisions by the business judgment rule. While agency-cost problems may underlie some greenmail payments, we have suggested another explanation of greenmail here. Greenmail may not only be desirable from shareholders' perspective, but it can facilitate the efficient functioning of the market for corporate control.