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A Theoretical Analysis of Corporate Greenmail

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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.”¹ The tactic was little used until recently.² With the rise of “corporate raiders” like Victor Posner and Carl Icahn, however, greenmail payments are now more frequent and more controversial. Between April 1983 and April 1984, corporations

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1. “Negotiated stock repurchases” and “greenmail” are the terms used most often to describe a firm’s purchase of its own common stock at a premium above the current price. The practice has other names, such as “targeted stock repurchases,” or simply the “goodbye kiss.” See Dann & DeAngelo, *Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control*, 11 J. FIN. ECON. 275 (1983). The practice of making a lump sum payment to a firm or individual in exchange for an agreement not to proceed with a tender offer, even when no purchase of stock is made, is also referred to as greenmail. When the agreement freezes a shareholder’s interest at a certain percentage, it is known as a “standstill agreement.” These agreements are generally thought to be analytically equivalent to greenmail, which also stipulates the permissible ownership of the contracting shareholder, but sets it at zero. Later in this Article we suggest why greenmail and standstill payments assume the various forms they do. See *infra* text accompanying notes 79–85.

2. “Once rare, these dramatic buyouts are increasingly the defensive tactic of choice among managers” Kirkland, *When Paying Off a Raider Benefits the Shareholders*, FORTUNE, April 30, 1984, at 152.

paid over four billion dollars to repurchase blocks of stock from individual shareholders.³ In March 1984 alone, four major American companies bought out holders of large minority blocks of shares at substantial premiums, including Warner Communications' repurchase of 5.6 million of its shares from Rupert Murdoch at 33 percent above the market price.⁴ Saul Steinberg's greenmail agreement with Walt Disney Productions, concluded later in 1984, was perhaps the best-publicized negotiated repurchase of all.⁵

As the terms suggest, payment of "greenmail" to "raiders" has generally not met with approval. It has been called everything from "extortion"⁶ and "a disgrace"⁷ to "[u]nfair, unjust, [and] wrong."⁸ Such negative opinions surface among "conservatives" as well as "liberals,"⁹ for "[n]early everyone agrees that greenmail should be stopped."¹⁰ Several different proposals, including legislative initiatives, have been offered to ban or regulate the practice.¹¹

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 (the "unfairness" objection to greenmail).¹² Second, critics claim that management pays greenmail in a self-serving attempt to prevent a shift in corporate control that would threaten their

3. These figures are based on a survey by Kidder, Peabody of common-stock block repurchases. This survey includes firms whose stock is traded on the New York Stock Exchange, the American Stock Exchange, and over-the-counter. The study is discussed at some length in Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 281-92 (1984).

4. See Kirkland, *supra* note 2, at 152. The other corporations paying greenmail in March 1984 were Texaco, Quaker State Oil, and St. Regis. *Id.*

5. Disney paid Steinberg \$77.50 per share when the market price of Disney shares was \$65.13. Boland, *Missing the Bottom Line on 'Greenmail'*, Wall St. J., July 25, 1984, at 26, col. 4. Though perhaps the best publicized, Steinberg's greenmail deal was not the most lucrative. That honor apparently belongs to Bass Brothers Enterprises, which made an estimated \$400 million profit in selling back its Texaco holdings. Kirkland, *supra* note 2, at 153.

6. Peter Solomon, Chairman, Lehman Brothers Mergers and Acquisitions Department, *quoted in* Meisler, *Mergers and Divestitures: The Pace Quickens*, FORBES, Nov. 5, 1984 (Special Advertising Supplement), at 12.

7. Martin Lipton, *quoted in SEC Seeks Legislation To Limit Tender Offer Abuses*, BNA CORP. PRAC. SER., April 10, 1984, at 2.

8. Peter Goodson, Chief, Mergers and Acquisitions Department, Kidder, Peabody & Co., *quoted in* Meisler, *supra* note 6, at 12.

9. See *infra* text accompanying notes 130-38 (describing legislative initiatives from both liberals and conservatives); see also COUNCIL OF ECONOMIC ADVISORS, ECONOMIC REPORT OF THE PRESIDENT 191 (1985) [hereinafter cited as ECONOMIC REPORT OF THE PRESIDENT] (suggesting that controls on greenmail "may be appropriate").

10. Toy, *The Raiders*, BUS. WEEK, March 4, 1985, at 89. See also Kirkland, *supra* note 2, at 152 ("[H]ardly anyone likes greenmail."); Siegel, *How To Foil Greenmail*, FORTUNE, Jan. 21, 1985, at 157 ("Greenmail has no redeeming virtues . . . [It] allows market professionals to hold American business for ransom.").

11. See *infra* text accompanying notes 126-38.

12. See *infra* text accompanying notes 119-25.

jobs. Under this view (the “agency-cost” hypothesis), 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.¹³

This Article presents a more complete theory of greenmail than has yet been attempted and examines the explanation of greenmail offered by those who would regulate the practice. As shown in Section I, greenmail payments can actually improve the price shareholders receive in tender offers by facilitating an auction market for a firm’s stock (the “shareholder-welfare” hypothesis). In addition, greenmail payments can be an efficient means of compensating those who supply valuable information to the market (or the firm) about the value of a firm’s stock. As such, greenmail may be in the shareholders’ interest.

Having elaborated a positive theory of greenmail from a shareholder perspective, Section I then discusses the social welfare implications of greenmail relative to other anti-takeover management tactics, a subject of more general controversy. Professors Easterbrook and Fischel in particular argue for a legal rule prohibiting defensive tactics by managers (though they do not consider greenmail specifically).¹⁴ This Article argues, however, that greenmail differs from other defenses against takeovers in important respects that so far have gone unrecognized. The problems Easterbrook and Fischel associate with defensive techniques—free-riding on the production of information, reduction in monitoring of managerial performance, and deadweight loss from the consumption of real resources—do not arise in the payment of greenmail.

Section II analyzes the agency-cost and unfairness objections to greenmail. While management and shareholder interests may diverge sharply at times, we conclude that the agency-cost explanation of (and objection to) greenmail is at best incomplete and is in many respects unsatisfactory. It ignores circumstances in which shareholders themselves would want greenmail paid. And, even if management pays greenmail to preserve its employment, the agency-cost and unfairness objections are inadequate if greenmail also offers substantial benefits to the shareholders. Consistent with our argument, the empirical evidence on greenmail discussed in Section II indicates that payment of greenmail has benefitted repurchasing firms in many instances.

Section III discusses the law currently applicable to greenmail and pro-

13. See *infra* text accompanying notes 87–118.

14. Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) [hereinafter cited as *Auctions*]; Easterbrook & Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1194–95 (1981) [hereinafter cited as *Management Role*].

posals to regulate or prohibit such payments. When challenged in court in the past, payment of greenmail has been upheld under the business judgment rule. Courts, however, may be shifting away from this approach. Contrary to this trend and to current regulatory proposals that would make greenmail subject to stricter scrutiny, we argue that there is insufficient reason (theoretical or empirical) for any change in the law.

Our argument is not that greenmail is never abused or that unacceptable agency costs are never imposed. Ours is an "advocacy piece" only in the sense that we believe the different reasons for paying greenmail, including those beneficial to shareholders, need to be distinguished. To avoid repeated qualification, we admit from the start that some aspects of the greenmail process remain unexplained, though we believe these are less important than those we can explain. We hope that others will build on our model to elucidate the greenmail phenomenon further. In the meantime, an inability to explain certain aspects of exchanges among freely contracting parties does not necessarily mean that the exchanges themselves are socially undesirable. And even if the exchanges harm some firms, those same transactions may benefit others. Some firms may wish to restrict use of greenmail for themselves; others may not.¹⁵ Regulatory or judicial changes¹⁶ that would restrict greenmail across the board deprive shareholders in at least some firms of a legitimate means of protecting or advancing their interests in certain situations.¹⁷

I. A THEORETICAL ANALYSIS OF GREENMAIL

This Section offers a theoretical framework for evaluating the desirability of greenmail payments. As a first step, we isolate the agency-cost problem of self-serving managers that constitutes the fundamental objection to negotiated stock repurchases. To do this, we present a model in which shareholders monitor and can replace agents costlessly, and thus in which there are no agency problems.¹⁸

Our model, however, does not require that managers act altruistically,

15. Nothing prevents a firm from enacting charter revisions that prevent greenmail from being paid. *See infra* text accompanying notes 93-94.

16. Because individual firms may find it desirable to craft rules pertaining to greenmail that conform to their particular needs, we argue that firms should be permitted to contract around the applicable law provision. *See infra* text accompanying notes 162-71.

17. The SEC has proposed legislation to forbid targeted share repurchases unless the repurchase is approved by a majority of shareholders. Only repurchase offers extended to all shareholders would be exempt from the shareholder vote requirement. *See infra* notes 130-32 and accompanying text. One SEC Commissioner, Charles L. Marinaccio, supports an outright ban on greenmail payments. Marinaccio views the practice as "extortion." BNA CORP. PRAC. SER., No. 317, January 22, 1985, at 1.

18. This allows us to posit a "best case" in which greenmail has several advantages for target-firm shareholders.

or even that managers believe they are doing so. Thus, in Section II we will relax the “best case” assumption of costless shareholder monitoring, and introduce divergent managerial incentives into the model. While adding to the reality of the model, introduction of potential agency-costs does not change its conclusion. Rational shareholders may still give managers the discretion to make greenmail payments, even recognizing that managerial and shareholder incentives do not always coincide. The interests of shareholders may be served even when managers act perfectly selfishly. If, for example, managers pay greenmail solely to keep their jobs in the face of a hostile tender offer, but the payment causes the value of the company’s shares to go up, rational profit-maximizing shareholders will permit even self-interested managers to pay greenmail.¹⁹ The ultimate test of management action is not motive, but result. Moreover, the model illustrates that payment of greenmail may improve the functioning of the market for corporate control and enhance economic efficiency.

This Section is divided into two parts. The first deals with theoretical justifications for greenmail where there is a realistic threat that the greenmailer can obtain control of her target and jeopardize the jobs of incumbent management. The second part considers greenmail payments where there is no realistic threat of a shift of control and thus no threat to the jobs of incumbent management.

A. *Greenmail Payments in Response to Takeover Threats*

In a hypothetical world of costless shareholder monitoring (i.e., one in which the interests of shareholders and their manager-agents are perfectly aligned), we begin by asking what the reaction of a firm’s majority shareholders would be to the purchase of a substantial minority block of shares. The majority’s response critically depends on whether incumbents (I) believe that the minority purchaser (M) has assembled the block for passive investment purposes or as a springboard for a future takeover bid.

The relation between the value of the firm under incumbent ownership-management (V_I) and its prospective value under the ownership-management of the current minority shareholder (V_M) dictates whether a minority shareholder will find it advantageous to acquire control, or simply to remain an investor. If the value of the firm is greater in the hands of the current management ($V_I > V_M$), the substantial minority position will only be for purposes of investment; acquisition of the minority block has nothing to do with a corporate “raid.” (The issue of minority “bluffing” to elicit greenmail is discussed later.²⁰) In fact, many, if not most,

19. See *infra* text accompanying notes 98–99.

20. See *infra* text accompanying notes 79–80.

acquisitions of substantial minority holdings are made only for investment.²¹ By definition, as long as the minority holds for investment only, the majority has no reason to expect her to make a takeover bid.

In some cases, however, the value of the firm will be greater if control is placed in the hands of the current minority ($V_M > V_I$). In these circumstances, the minority stake may be acquired in contemplation of a future tender offer. The acquisition of the minority holding thus provides a signal to the market, transmitting information that the firm's shares are thought to be undervalued in the hands of incumbents relative to their prospective value in the hands of others. Share prices begin to rise in anticipation of a possible takeover.

What would be the appropriate majority response under these circumstances? This inevitably will depend on whether or not the majority shareholders believe that the minority owner will offer the best price to obtain control and, if a higher offer is predicted, what the cost of eliciting it will be. News that the new minority holder contemplates a takeover alerts other potential bidders that the firm may be undervalued. Incumbent management realizes that these other bidders may decide that they value the firm even more than the current minority and thus would be willing to offer an even higher price. If a higher premium over current market price can be obtained from some third party (T), net of the cost of obtaining it, the majority shareholders will of course prefer to thwart the takeover plans of the current minority in order to make way for an auction by other bidders and subsequent acquisition by a third party.²²

More formally, even if the firm would be worth more in the hands of the new minority than in the hands of its current owners, its value if owned and managed by a third party (V_T) may be even greater: $V_T > V_M > V_I$. If so, it is efficient for a third party to obtain control, as this

21. Mikkelsen and Ruback found that 55 percent of Schedule 13D filings from 1978-80 reported acquisitions of 5 percent share blocks that apparently were made for investment purposes only. Mikkelsen & Ruback, *Corporate Investments in Common Stock* 8 (Table 1) (Mar. 1984) (M.I.T. Working Paper 1559-84). Any person, other than the issuer, who acquires control of more than 5 percent of a class of registered equity securities must file with the SEC a Schedule 13D containing a statement of the purpose of the acquisition, and, specifically, whether the purchase is for investment or for the purpose of acquiring control of the target firm. 17 C.F.R. § 240.13d-1 (1984). See also 15 U.S.C. § 78m(d)(1) (1981) (granting SEC authority to require submission of information). Mikkelsen and Ruback inferred that investment was the motive from statements to that effect in the Schedule 13D filing itself or from the absence of any information in the Schedule about the firm's plans. Mikkelsen & Ruback, *supra*, at 7. The filings can later be amended, of course, but even as of December 31, 1981, fully 43 percent of the initial acquisitions were still being held, apparently for investment only. *Id.* at 8.

22. The fact that shareholders would want an auction after the takeover is threatened does not mean that they would agree to allow auctions *ex ante*, or that auctions are necessarily efficient. We defer consideration of these questions until we have explained the function of greenmail in facilitating auctions. The wider efficiency implications are considered *infra* text accompanying notes 59-78.

places the firm's resources in the hands of their highest-valued user.²³ As explained below, a third party can acquire control in two ways. He can either purchase the firm after the current minority owner completes the contemplated takeover, or he can try to enter the bidding for the firm at the first stage, competing with the minority holder in an auction for control of the firm. Ignoring transaction costs, the highest-valuing party will ultimately control the firm either way. But that does not mean that incumbent shareholders are indifferent to the process. It is in the interest of the incumbents to capture for themselves the largest possible share of any gain from a change in control. With positive transaction costs, this may be accomplished by having as many additional parties as possible bid against M for control. T, as the highest-valuing bidder among them, will be willing to offer the greatest premium, up to $(V_T - V_I)$. The premium of the current minority would be at most only $(V_M - V_I)$. So, in light of positive transactions costs, the incumbents prefer selling directly to T, instead of selling to M who then sells to T.

1. Bidder Tactics, Shareholder Strategies, and the Uses of Greenmail

It is important to see exactly why incumbent shareholders might not be able to sell their shares directly to the third party, even though T would ultimately offer a greater premium than the current minority shareholder, M. In the modern battle for corporate control of large, publicly-held firms, the principal weapon in the arsenal of the tender offeror is the two-tier or two-step bid.²⁴ Typically, after a firm has acquired a significant minority block of stock in another firm through open-market purchases, it takes the first step by acquiring a controlling interest in the target firm.²⁵ In the second step, the bidding firm causes a merger between itself (or a wholly-owned subsidiary) and the target firm.²⁶ This merger eliminates the equity interests of the remaining shareholders in the surviving firm. This second step is commonly referred to as a "take-out merger," or more pejoratively, as a "freeze-out merger."²⁷

23. Takeovers themselves have been shown both theoretically and empirically to increase the share prices of target firms. See, e.g., *Management Role*, *supra* note 14, at 1165-74; Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders Welfare*, 36 BUS. LAW. 1733, 1734-45 (1981).

24. SEC, *Two-Tier Tender Offer Pricing and Non-Tender Offer Purchase Programs* (1984) (unpublished mimeograph) [hereinafter cited as SEC, *Two-Tier Pricing*].

25. See Carney, *Shareholder Coordinator Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. BAR FOUND. RES. J. 341, 347-53.

26. *Id.* The 1982 United States Steel merger with Marathon Oil illustrates the two-step merger. U.S. Steel obtained control of Marathon with a cash tender offer of \$125.00 per share for 51% of Marathon's outstanding common stock. U.S. Steel then acquired the remaining 49% of the stock for \$86.00 in a post-tender-offer merger. *Radol v. Thomas*, 534 F. Supp. 1302, 1305 n.2 (S.D. Ohio 1982).

27. Thus, a take-out merger is a merger in which a dominant shareholder or shareholder group

Single-tier (or "any-or-all") bids, by which bidders agree to purchase all shares tendered at a given price, are used more frequently than explicit two-tier bids or partial offers when the target firm is relatively small.²⁸ But as target firm size increases, two-tier bids replace any-or-all offers as the most common form of tender.²⁹ And, though a bidder may not announce a second (take-out) step initially, seventy-two percent of successful tender offers are followed within five years by a take-out merger.³⁰ We use a two-tier bid to illustrate the mechanics of greenmail, not because our model is limited to that context, but simply because of the prevalence of two-tier offers in takeovers of large, publicly-held companies.³¹

The beauty of the two-step takeover (in the eyes of the bidder) is that it places the shareholders of the target firm in a prisoner's dilemma that leads them to tender their shares.³² This prisoner's dilemma gives the initial bidder (M) a tactical advantage over subsequent bidders.³³ For the tactic to succeed, however, the initial bidder must elicit tenders before a

votes for a merger in which the minority shareholders will not have an equity interest in the surviving firm. See Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624 (1981). For overviews with contrasting evaluations of freezeouts, see Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 723-31 (1982); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978). See also Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987 (1974); Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974); Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019 (1975); Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); Lorne, *A Reappraisal of Fair Shares in Controlled Mergers*, 126 U. PA. L. REV. 955 (1978); Toms, *Compensating Shareholders Frozen Out in Two-Step Mergers*, 78 COLUM. L. REV. 548 (1978).

28. See SEC, *Two-Tier Pricing*, *supra* note 24.

29. *Id.*

30. Dodd & Ruback, *Tender Offers and Stockholder Returns: An Empirical Analysis*, 5 J. FIN. ECON. 351, 352 n.2 (1977); cf. Carney, *supra* note 25, at 348-49 (discussing empirical evidence).

31. Even without two-tier bids, greenmail is still of value to target shareholders whenever additional time following an initial offer facilitates the development of an auction for their shares. For example, in an all-or-nothing bid the offeror generally conditions her offer on receiving a certain percentage of the outstanding shares by a certain date. This decreases the likelihood of subsequent bidders trumping the initial offer. Under such circumstances, greenmail may be a useful device for "buying time" to see if better offers develop. See *infra* text accompanying notes 50-58.

32. Game theorists use the term "prisoner's dilemma" to describe a situation where the inability of individuals to coordinate their decisions leads to a suboptimal result from the perspective of the decision-makers. Brudney and Chirelstein were the first to describe the situation facing target shareholders as a prisoner's dilemma. See Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, *supra* note 27, at 337 (describing "whipsaw effect" of two-tier bid on shareholders). For a description of the prisoner's dilemma game, see P. SAMUELSON, *ECONOMICS* 482-83 (8th ed. 1970); P. ARANSON, *AMERICAN GOVERNMENT: STRATEGY AND CHOICE* 54 (1981).

33. As applied to the tender-offer situation, initial bidders have an advantage because the best strategy for each target shareholder is to choose to tender even though a better solution would be for them to agree not to tender. Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 31-33 (1983); Bebchuk, *The Case for Facilitating Tender Offers*, 95 HARV. L. REV. 1028, 1040 n.59 (1982); but see Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 860 (1981) (arguing that shareholders are not placed in a true prisoner's dilemma because the gain from the premium offered is greater than the anticipated loss on shares retained). For further discussion of the prisoner's dilemma operating in the tender-offer situation, see *Management Role*, *supra* note 14, at 1173-74 n.33.

competing bidder can enter the market. A higher blended price offered by a subsequent bidder will defeat the offer of the initial bidder.³⁴

To illustrate, suppose that the current price of a firm's stock is \$30 per share. The firm has 101 shares outstanding and M has acquired as a "toehold" one of these shares in an open-market transaction. She purchased the stock after investing \$40 in research indicating that under her ownership/management the value of the firm would increase to \$37 per share. The remaining 100 shares are divided evenly between two people, A and B, neither of whom is able to contact the other one without incurring prohibitive costs.³⁵

In this situation M would make, or threaten to make, a two-tier offer for all of the remaining shares. M would promise to pay a premium for the first fifty shares, but she would also announce that she would follow with a take-out merger for the remaining fifty shares at the pre-tender offer price of \$30. Suppose that the bid is to purchase the first fifty shares for \$40 each and the remaining 50 for \$30 per share, acquiring all shares at an average price of \$35.³⁶ When (and if) the acquisition is completed, the price will climb to \$37 under M's management, giving M a gross return of \$207 (\$200 on the 100 shares purchased from A and B, plus \$7 on the initial share), and profits of \$167 once her research costs are subtracted.

34. This proposition is demonstrated empirically in SEC, *Two-Tier Pricing*, *supra* note 24, at 53-55 (Table 9). Prior to the passage in 1968 of the Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (codified as amended in scattered sections of 15 U.S.C.), bidders made their purchases on a first-come-first-served basis and limited their offers by requiring target shareholders to tender within a relatively short time. Carney, *supra* note 25, at 347. The Williams Act limited these practices. *Id.* Under current law, a tender offer must be held open for a minimum of twenty days. 17 C.F.R. § 240.14e-1(a) (1984). Bidders are required to purchase all shares that are tendered during this period on a pro rata basis. SEC Rule 14d-8 (1982), SEC Exchange Act Release No. 19336, 1982-83 FED. SEC. L. REP. (CCH) ¶ 83,306 (Dec. 15, 1982). See *Management Role*, *supra* note 14, at 1162.

35. In the context of actual tender offer situations in publicly held firms, the prisoner's dilemma results from the high costs to diverse shareholders of communicating among themselves. The prisoner's dilemma is exacerbated in the publicly-held firm because individual shareholders who expend resources to communicate information to fellow shareholders bear all of the costs of such communication, but share the benefits collectively with all other shareholders. The efficiency of capital markets makes the dilemma even more acute. Investors who expend resources to uncover information and then attempt to capture the value of their investment by purchasing shares signal the nature of their discovery to other investors; this prevents the initial investor from capturing the full value of her informational investment. See Scholes, *The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices*, 45 J. BUS. 179 (1972).

36. The question of how an initial bidder chooses the blended price in a two-tier bid is of considerable interest in itself, but is not addressed here. At a minimum, to create a prisoner's dilemma, the first-tier bid must be higher than the blended bid expected from a third party. The minority shareholders' "appraisal rights" also set a lower limit for the second-tier bid. See W. CARY & W. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 1452-62 (5th ed. 1980) (discussing appraisal rights); see also Manning, *The Shareholder's Appraisal Remedy: An Essay For Frank Coker*, 72 YALE L. J. 223, 229 (1962) (consequence of appraisal remedy was to "consolidate and liberate" management); Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1, 85 (1969) (appraisal called "remedy of desperation").

The threatened bid, however, provides useful information to others that the firm may be undervalued.³⁷ The news causes other parties to look at the firm, and A and B may be convinced that at least one of the third parties, T, would place a higher value on the firm than does M ($V_T > V_M$), and would be willing eventually to make a better offer, say an average of \$39 per share instead of M's \$35 per share.³⁸ But A and B are in a classic prisoner's dilemma as illustrated in the matrix below.

		A's CHOICES	
		NOT TENDER	TENDER
B's CHOICES	NOT TENDER	39 / 39	40 / 30
	TENDER	40 / 30	35 / 35

M often has the advantage of having developed her information first and so will be able to offer and complete acquisition of control before T can make his own bid. If A doesn't tender to M and B does, B receives \$40 for his shares and A receives only \$30. On the other hand, if A and B both tender, B still receives an average of \$35 for his shares. Under these circumstances, B is better off tendering his shares, regardless of whether A tenders or not. By tendering, B earns at least \$5 and perhaps \$10 over the current market price for the shares; by not tendering he loses any premium. A, of course, is in exactly the same position and will act in the same way. The result is that both will tender. Under current law, the offeror, M, will be required to purchase the shares pro rata. A and B will

37. "The bid itself . . . may reveal much of what the offeror has learned. . . . Indeed, the existence of an offer by itself tells other prospective bidders where to look, even if it conveys no other information." *Management Role*, *supra* note 14, at 1178 & n.45; *see also* Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. Bus. 345, 347 (1980); Scholes, *supra* note 35.

38. T's willingness to pay \$39 per share of course implies that the firm is worth more than \$39 to T.

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each receive \$40 for 25 of the shares they own and \$30 for the remaining 25 shares. If the two could communicate, they would both agree not to tender any of their shares and hold out for the later, higher offer of \$39 per share from T. The inability of A and B to coordinate their activities results in a total loss to them of \$400.³⁹

In the real world, of course, there will never be complete certainty that a subsequent bidder will appear. The probability of obtaining control of the firm may not be great enough to induce any additional parties to bid. Assembling the information needed to value the target firm is costly, as is making the bid itself. If the probability of a successful bid is sufficiently low, the expected value of the takeover to other parties may fall short of the costs. If so, a given third party would not choose to enter the bidding contest, although he could be the highest-valuing user of the firm's resources and would have offered the greatest premium to incumbent shareholders.

Shareholders, though, can affect the probabilities so as to increase the size of their premium. Just as M can raise her likelihood of success by shortening the time her offer is open, incumbent shareholders A and B can influence the probabilities the other way. By adopting "shark repellent" amendments,⁴⁰ litigating, or otherwise opposing the minority owner, incumbents lower the probability of minority success and raise the chances of a third party prevailing. (Resort to these tactics has wider efficiency and thus social-welfare implications, to which we return below.⁴¹) Such defensive tactics, however, may not be the least expensive way to block the lower-valuing bidder. An alternative is simply to win time for T to put together his offer—by paying "greenmail."

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.

To return to the numerical example above, suppose again that the target firm's stock trades at \$30 a share. This price reflects the market's

39. If A and B could coordinate their actions, they would receive a total of \$3900 from the sale of their shares (100 shares x \$39 per share). If A and B tender their shares to M each will receive \$40 for half and \$30 for half. This results in an average price of \$35 and a total of \$3500 ((\$30 x 50 shares) + (\$40 x 50 shares)). The difference of \$400 represents the cost to A and B of being unable to coordinate their strategy.

40. Shark repellent amendments take a variety of forms. They may require that (1) target shareholders approve mergers and sales of assets to related shareholders by a majority above that required by statute; (2) holders of a majority of the shares not taken in the original tender offer approve any merger or sale of assets; or (3) the price paid in the second stage take-out merger exceed a certain level. For a general discussion of shark repellents, see Carney, *supra* note 25, at 373-82.

41. See *infra* text accompanying notes 59-78.

expectations about future events, including takeovers.⁴² 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 \$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 \$25 per share. The firm's current worth of \$30 per share is the sum of the expected values of the two events ($\$35 \times .5 + \$25 \times .5 = \$30$).

Now suppose that the target firm considers installing shark repellent amendments. These amendments might require that all hostile tender offerors pay an average price of \$39 per share to acquire the target firm, which is the amount A and B believe some third party T will ultimately offer.⁴³ These shark repellent amendments, however, inevitably lower the probability of a tender offer taking place at all. As such, the expected price premium must be correspondingly greater if shark repellents are to be attractive to shareholders. For example, 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 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 \times .4 + \$25.00 \times .6 = \30.60). In this case, shark repellents are advantageous to shareholders and would be adopted if they were the only defensive tactic available. Shareholders, however, inevitably will search for an even better device to mitigate the effect of the prisoner's dilemma and buy time for T's subsequent bid. As we now show, 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

42. "The value of any stock can be understood as the sum of two components: the price that will prevail in the market if there is no successful offer (multiplied by the likelihood that there will be none) and the price that will be paid in a future tender offer (multiplied by the likelihood that the future offer will succeed). A shareholder's welfare is maximized by a legal rule that enables the sum of these two components to reach its highest value." *Management Role, supra* note 14, at 1164. In reality, of course, the value of a stock reflects a whole range of prices and probabilities, but more complex arithmetic would not advance the analysis here.

43. In our numerical example, the possibility that a third party might offer \$39 per share did not enter into the calculation of the firm's share price prior to the installation of shark repellent amendments. This possibility only arose after the shark repellent amendments were installed. Before such amendments, the tender offeror, M, could exploit the prisoner's dilemma facing A and B and thereby acquire the target firm for a blended price of \$35.

greater opportunity to formulate their bids. For both reasons—more information and more time—greenmail *raises* the probability of some bidder T making an offer, and of an auction developing that will increase the price of a successful tender.

Suppose that M would accept a \$200 payment not to acquire any more shares of the target firm.⁴⁴ Suppose further that the probability of a successful tender offer by T rises to 80 percent once the greenmail is paid. What average price will T offer? Before the greenmail, he would offer an average of \$39 per share, but the greenmail has reduced the firm's assets by \$2 per share. T therefore will only offer \$37, making the value of the stock \$34.20 per share ($\$37.00 \times .8 + \$23.00 \times .2 = \34.20). Greenmail makes the stock more valuable than if A and B impose shark repellent amendments,⁴⁵ and certainly more valuable than if they do nothing.⁴⁶

All defensive tactics have the virtue of mitigating the effect of the prisoner's dilemma that faces target shareholders, and thus of raising the aggregate price that a successful bidder must pay for target shareholders' stock. Jarrell has demonstrated the magnitude of shareholders' higher premium gains in a recent empirical study of target-firm litigation against initial tender offerors.⁴⁷ Unlike greenmail, however, other defensive tactics pose significant risks to the shareholders of target firms. When faced with these tactics, would-be bidders might find the cost of acquiring the target prohibitive, and may never make a bid in the first place.⁴⁸ The higher premiums from resisting tender bids come at some risk that no takeover will subsequently occur.⁴⁹

44. The question of the sums that A and B would be willing to offer in greenmail and that M would accept is of considerable importance and some complexity; we return to it below. See *infra* text accompanying notes 51–58.

45. The value of the stock with shark repellent amendments is \$30.60 per share. See *supra* text accompanying note 43.

46. The value of the stock if A and B do nothing is \$30.00 per share. See *supra* text accompanying note 42.

47. Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merger?*, 28 J.L. & ECON. 151 (1985). Taking a sample of firms that have resisted initial tender offers by litigating against the bidder, Jarrell finds that the expected gains to target firms from higher subsequent bids outweigh the costs both from the litigation and from the risk that the tender offer will be defeated but no subsequent offer will be made. Defensive tactics, that is, may be "sensible gambles, rather than shameful self-dealing by managers." *Id.* at 175.

48. In addition to the risk that no bid will be forthcoming, there is also the risk that the defense will succeed without a subsequent bid being made. Jarrell found for his sample that litigation against a tender offeror carried a risk of almost 25% that no take-over would occur after an initial tender offer was defeated by litigation. *Id.*

49. Even with agency costs, managers will select the particular defensive tactic that imposes the lowest costs on shareholders for any given level of job protection. Managers have no incentive intentionally to inflict costs on shareholders when less costly alternatives will provide the same job protection. Thus, even an agency-cost explanation of greenmail does not necessarily imply that these payments should be regulated or banned, since interference may only result in managers' selecting some other, more costly defensive tactic to ward off potential acquirors. Those who advocate the regulation of greenmail neglect the possibility that managers who wish to avoid losing control will look for an

When no takeover ensues, everybody loses.⁵⁰ Thus, the payment of greenmail where there is a realistic threat of a takeover allows target shareholders to "have their cake and eat it too." 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 offerors 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.

Shareholders must pay for the privilege of both having and eating, however. How much would A and B offer to M not to make a tender offer? Up to \$360, the increase in firm value that M provides over the shark repellent alternatives—\$3.60 per share times their 100 shares.⁵¹ But will this be enough to induce M to accept the greenmail? Minority shareholders do not have to accept greenmail, of course. They can simply proceed with their tender offer if they do not think the payment is high enough. To know whether or not M will accept a greenmail offer of just under \$360 requires additional factual assumptions about M's likelihood of success if she makes a tender offer and about the transaction costs of successive tender offers. If M is certain to acquire control of the target firm at an average price of \$35 and can costlessly resell to T for \$39, her gains *ex ante* are \$409 (\$4 per share on the 100 purchased from A and B plus \$9 appreciation on the one share purchased earlier). In that situation, no greenmail deal is possible: M is able to garner all the rewards of her discovery of the undervalued stock.

But M cannot be certain of obtaining control of the target (though her position as first bidder increases her probability of success), and particularly cannot be sure that a third party, T, will make a bid. To make an extreme assumption,⁵² if there is no possibility that T will make a bid to

alternative strategy if they are precluded from paying greenmail. As indicated here, these alternatives (shark repellents, litigation, and the like) are probably less desirable to shareholders and to society than greenmail is.

50. See Easterbrook & Jarrell, *supra* note 3, at 281-91 (summarizing evidence).

51. As shown above, the stock price of the firm willing to pay greenmail is \$34.20, \$3.60 more than the \$30.60 price that will prevail if the firm installs shark repellents.

52. T might not be expected to make the same proposal to M after M acquired the target that T would have made to A and B. First, the gains to T have fallen, as the stock is now selling at \$37 rather than \$30. The expected costs to prepare a bid may exceed the expected gains. Another reason is possibly higher transaction costs. Professor Gilson believes that successive tenders are more costly than auctions. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51, 62-64 (1982). In that case, T is less likely to make an offer and M would accept a lower greenmail payment. Easterbrook and Fischel argue, however, that the transaction costs of successive tenders are lower than the costs of an auction; if so, T is more likely to make an offer, increasing the amount of greenmail M would demand. *Auctions*, *supra* note 14, at 12.

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repurchase from M, M will prefer to accept \$200 in greenmail even if M's chance of successfully completing a takeover is 90 percent.⁵³ But if M faces an 80 percent chance that T will make an offer to her at \$37, the amount of her greenmail must be increased substantially or else there will be no agreement.⁵⁴ If the probability of M reselling to T at \$37 is as high as 90 percent, there will be no greenmail offer acceptable to A and B that is high enough for M to accept.⁵⁵

It is not necessary for our purposes to formalize the bilateral monopoly bargaining model that would determine the precise amount of greenmail acceptable to both sides.⁵⁶ We merely note that situations may arise where the gains to M from making a tender offer will be less than the gains to A and B if M does not offer. The size of those gains depends on the factors identified above, namely, the size of the premiums at stake, the probability that M will succeed in her initial offer, and the probability that T will subsequently offer to repurchase.⁵⁷ The greater these two probabilities, the less M will find greenmail attractive, all other things being equal. The relevant probabilities in turn depend on exogenous factors like transaction costs and regulatory impediments. For example, the federal statute regulating tender offers (the Williams Act), by making it less probable that an initial offeror will succeed, may make it more likely that M will find greenmail acceptable.⁵⁸

53. If M successfully completes her offer but does not expect to resell to T, she will gain \$207. *Ex ante*, with a 90 percent chance of completing the offer, the expected gain is \$186.30. The greenmail offer of \$200 will therefore be acceptable to M. Of course, since the greenmail is worth more than \$200 to A and B, M may be able to bargain for more. This is the familiar bilateral monopoly situation, in which price is indeterminate. See G. STIGLER, *THE THEORY OF PRICE* 207-08 (3d ed. 1966).

54. The sale of her shares to T at a \$2 premium would earn M another \$202, whose expected value with an 80 percent chance of making the sale is an additional \$161.60. Combined with the expected value of the acquisition itself of \$186.30, *see supra* note 53, the total expected value of the initial purchase to M, including the resale of the shares to T, is \$347.90. To be acceptable to M, therefore, any greenmail must extract over 95% of the \$360 gain that A and B would receive in selling to T.

55. If M's chances of reselling to T are 90 rather than 80 percent, the total value of the acquisition and resale becomes \$368.10, which exceeds the maximum greenmail that A and B would offer.

56. See G. STIGLER, *supra* note 53, at 207-08.

57. See *supra* note 52.

58. The Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended in scattered sections of 15 U.S.C.), by increasing the time that tender offers must be kept open, would increase the demand by initial offerors for greenmail as insurance against becoming the victims of a free ride. But firms' supply of greenmail would shrink because the Williams Act furthers the goal of giving subsequent bidders more time to put together competing offers, which is one function of greenmail. On the supply side, therefore, the Williams Act is a substitute for greenmail. It is unclear, *a priori*, whether the demand or the supply reaction of greenmail to the Williams Act would dominate. Ironically, the proposals to restrict greenmail conflict with the stated goal of the existing statutory scheme, which is to aid target company shareholders by allowing them more time to make decisions. Greenmail accomplishes the same thing. Thus, corporate greenmail payments achieve by contractual arrangement what the Williams Act attempts to provide by statute.

2. *Welfare and Efficiency Implications of Greenmail*

The fact that, once a tender offer becomes imminent, shareholders may want to pay greenmail as a defensive tactic to initiate an auction market does not necessarily mean that greenmail is wealth-increasing *ex ante*. Use of defensive tactics against takeover bids has provoked considerable controversy. Easterbrook, Fischel, Bebchuk and Gilson have all argued that managerial resistance to tender offers by tactics that can actually defeat offers (e.g., scorched-earth tactics, poison pills, shark repellents, vexatious litigation) should never be permitted.⁵⁹ Easterbrook and Fischel advocate a rule of complete managerial passivity that would make it illegal for a firm to do anything other than conduct the firm's ordinary business in the face of a tender offer. Their rule would bar even those defensive tactics that do not defeat tender offers but help to create an auction market for the target firm's shares (e.g., mandatory periods before which initial offers can be completed). Bebchuk and Gilson part company from Easterbrook and Fischel on this point.⁶⁰

Easterbrook and Fischel recognize, of course, that resistance may elicit a higher bid, either from the original offeror or from a second bidder, as an auction market for the firm is created. But they see two overriding objections to defensive tactics that lead to auctions and takeovers at higher premiums.⁶¹ The first is the ability of third parties to free-ride on information gathered by the first offeror at some cost. The free ride means that less information is produced, which in turn reduces outside monitoring of managerial performance. Second, Easterbrook and Fischel object to defensive tactics, even those creating auctions, because the measures consume real resources. Neither of these objections—informational free-riding or consumption of valuable resources—applies to greenmail, however. Indeed, as seen below, greenmail solves or mitigates the principal problems with defensive tactics identified by Easterbrook and Fischel.

a. *The Free-Rider Problem and Greenmail*

The transfer of resources from lower- to higher-valuing users not only raises firms' share prices, but also increases total wealth and so performs an important social function.⁶² Prospective tender offerors make considerable contributions to the process of value-creation, by locating undervalued assets and providing the information to move them to those who can use them more efficiently. But potential bidders are exposed to victimiza-

59. *Management Role*, *supra* note 14; Bebchuk, *supra* note 33; Gilson, *supra* note 33.

60. *Compare Auctions*, *supra* note 14, with Bebchuk, *supra* note 33; Gilson, *supra* note 52.

61. *Management Role*, *supra* note 14, at 1174-82.

62. *See supra* note 23.

tion by others who can free-ride on the information produced and thus reap returns from information for which they did not pay.⁶³ Even if no defensive tactics are used, subsequent bidders can take advantage of the information created by the initial bidder because “using information often gives it away.”⁶⁴ The initial bid signals to other investors that undervalued assets have been located. Because the subsequent bidders have incurred no costs to acquire information, they can offer more to target-firm shareholders, forcing the initial bidder to increase her offer or lose the opportunity to acquire the target firm.

By increasing the premium a first offeror must pay and/or by reducing the likelihood of her offer succeeding, defensive tactics (including those that encourage creation of auctions) reduce a bidder’s incentive to locate attractive targets and invest in first offers. Defensive tactics employed once the initial bid is made afford subsequent bidders an even greater opportunity to free-ride on information generated by the first bidder.⁶⁵ It is not just prospective initial bidders who are harmed, however. Fewer bids also harm shareholders of potential targets.⁶⁶ Thus, as Easterbrook and Fischel observe, the reduced incentive to scrutinize firms for undervaluation affects the entire market for corporate control:

[S]hareholders benefit [from tender offer bids] even if their corporation never is the subject of a tender offer. The process of monitoring by outsiders poses a continuous threat of takeover if performance lags. Managers will attempt to reduce agency costs in order to reduce the chance of takeover, and the process of reducing agency costs leads to higher prices for shares.⁶⁷

63. *Management Role*, *supra* note 14, at 1178–79. See also Grossman & Hart, *Takeover Bids, The Free-Rider Problem and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980) (analyzing shareholder’s ability to free-ride on takeover information).

64. *Auctions*, *supra* note 14, at 4. Easterbrook and Fischel have noted:

As a result, no firm wants to be the first bidder unless it has some advantage, such as speed, over subsequent bidders to compensate for the fact that only it had to incur monitoring costs.

And, of course, if there is no first bidder there will be no later bidders and no tender premium.

Management Role, *supra* note 14, at 1179 (footnote omitted).

65. In his study of resistance to tender offers by litigation, Jarrell is unable to account statistically for free-riding, but suggests its magnitude may be great enough to make managerial resistance socially undesirable:

[I]t is important to recognize that this conclusion—that litigious defenses can be beneficial to target shareholders—does not imply that such actions enhance social welfare. Indeed, the opposite is more likely to be true, because litigious defenses redistribute some of the gains from corporate combinations from acquirers to the targets. This redistribution is analogous to a tax on acquirers. Under the assumption that sunk investments by the acquirers produce the bulk of the gains to takeovers, this tax will deter future investments in this valuable acquisition-oriented information.

Jarrell, *supra* note 47, at 175.

66. *Management Role*, *supra* note 14, at 1180.

67. *Id.* at 1174 (footnote omitted).

In general, that is, defensive tactics reduce the number of tender offers launched, and so reduce aggregate firm value.

But greenmail is unlike other defensive tactics, in that greenmail actually *solves* the free-rider problem that lowers the probability of an ultimate takeover. The minority shareholder, by hypothesis, is the first to develop the information that the firm is undervalued. To maximize the premium it will receive, the firm must buy off the minority, paying in greenmail at least the expected value to her of the minority takeover. There is thus no free ride and no disincentive to the production of information, because greenmail compensates the minority for developing the information that the firm is undervalued.⁶⁸ Target firm shareholders obtain the ability to run an auction after their firm is identified, but must purchase the right to do so from the one who provided the information in the first place.⁶⁹

The implications of greenmail in avoiding free-rider problems are worth elaborating. The potential for free-riding on information arises because, absent greenmail, the returns for acquiring information normally can be captured only by a successful takeover bid. Gilson notes that the initial offeror's bid must cover two entirely separate costs: the bidder's search costs to discover the target, plus the amount paid to obtain control.⁷⁰ If the only way to reap any return for the investment in information is to implement the takeover, unsuccessful takeovers leave the information discovery uncompensated. Potential bidders will reduce the amount of search, and the production of information will be sub-optimal.

Under these circumstances, both demanders and suppliers of information have an incentive to establish a separate compensation system for the information itself, to "un-bundle" or "de-couple" the production of infor-

68. If the incumbent majority does not offer greenmail sufficient to compensate her for her investment, a minority shareholder can just refuse it and complete her takeover bid. As noted earlier, it is impossible to specify the price at which greenmail will be paid, because the sum will be the outcome of bargaining under bilateral monopoly and depends on various probabilities and costs. But at a minimum, the greenmailer must receive the full expected value to her of the takeover.

Bebchuk and Gilson have suggested that initial offerors can prevent a complete free-ride on the information they develop by buying a minority stake in the firm, which then appreciates when a subsequent bidder (while free-riding on the initial offeror's information) engineers a successful takeover. Bebchuk, *supra* note 33, at 1040; Gilson, *supra* note 33, at 871. Easterbrook and Fischel quite correctly note, however, that this only mitigates, but by no means dispels, the free-rider problem. *Auctions*, *supra* note 14, at 4-5. If the bidder acquires a 10 percent stake before making an unsuccessful first bid, she still loses up to 90 percent of the value of her information. With greenmail, by contrast, the greenmailer can capture the full value of her information.

69. Easterbrook and Fischel have noted: "If an auction increases the rate of return, and first bidders are rational profit maximizers, they will run auctions themselves—or give their blessings to the targets' managers." *Auctions*, *supra* note 14, at 20. An income-maximizing bidder would never "give her blessing" to an auction, but under some circumstances she would sell the right to hold an auction in exchange for greenmail. It is the fact that users of information must compensate its developers that distinguishes greenmail from other defensive tactics designed to stimulate auctions.

70. Gilson, *supra* note 52, at 53.

mation about a firm's value from the takeover itself. More information about firm values will then be produced, which benefits the firms themselves, and producers of that information will be more assured of compensation. Greenmail is one arrangement that de-couples compensation for information from completion of a takeover. The possibility of receiving greenmail gives greater assurance to the information producer that she will be compensated for the value of the information, even if she ultimately does not acquire control. The result is the production of more information and better monitoring of management performance.

Separate compensation also permits sellers of information to specialize. One who develops information about profitable takeover candidates may want simply to sell the information, rather than to manage the undervalued firm herself. There are gains from specialization in separating the discovery of information from acquisition and management of target firms.⁷¹ The third party T may have a comparative advantage over the minority shareholder M in managing the target firm while M has demonstrated a superior ability to discover undervalued resources. Therefore, parties will seek ways to de-couple the two functions and reward them separately. Specialization in producing information lowers its costs, leading to increases in information produced, takeover bids generated, and monitoring of management.

In short, there are gains to be made from trading among the parties if specialization is efficient. A bidder could pay a finder's fee directly to one who locates profitable acquisition opportunities. This is essentially the way investment banks are compensated,⁷² but one observes non-institutional developers of information performing the same function of selling information to takeover bidders.⁷³ Third parties are not the only ones who would demand the information developed, however. The target firm's incumbent majority also might be willing to pay for it, either to put it to use themselves or to pass it along to potential bidders or merger partners.

71. *Auctions*, *supra* note 14, at 18: "[L]earning about firms and taking them over are separate tasks. . . . Firms specializing in generating information might find their returns highest when they have other firms engage in tender offer auctions." For a discussion of how one notorious greenmailer, Irwin Jacobs, combines internal staff research and outside consultant evaluations to discover undervalued firms, see Gibson, *Motives of Enigmatic Investor Jacobs Are a Mystery Even to His Colleagues*, *Wall. St. J.*, Jan. 28, 1985, at 36, col. 1.

72. Gibson, *supra* note 52, at 58.

73. A recent case is illustrative. In *Flynn v. Bass Bros. Enterprises*, 744 F.2d 978 (3d Cir. 1984), a firm (Prochemco) had developed information that another corporation (National Alfalfa) was an attractive acquisition. Prochemco's information about National Alfalfa was contained in internal reports, including an appraisal of National Alfalfa's assets. Prochemco originally intended a takeover of National Alfalfa itself, but eventually sold the reports to Bass Brothers for \$130,000. Bass Brothers then used the information to acquire the firm. From the recitation of facts in the Third Circuit's opinion, Bass Brothers apparently had no inkling of the opportunity that National Alfalfa represented until alerted by Prochemco.

Target firms may in some situations be more efficient at locating higher-valued users of the firm's resources.⁷⁴ If so, target firms predictably would be the ones to purchase with greenmail the newly developed information from the minority shareholder.

A serial transaction, in which M acquired all of the shares of a firm at a premium over current market price and T then acquired control from M for an additional premium, would strike no one as unusual or objectionable. Greenmail merely telescopes these two transactions. When greenmail is paid, incumbent shareholders may in effect be making a side payment to M so that T can gain control. Since the firm's assets are worth more in T's hands than in M's, it is in everybody's interest—T's, M's and the incumbent shareholders'—that the payment be made. This is particularly true when the transaction costs of the side payment are significantly less than the transaction costs of two distinct corporate-control transactions.

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.

b. *The Consumption of Real Resources*

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.⁷⁵ The most obvious example is litigation, which consumes the time and talent of managers, legal staff, judges and so on. The dead-

74. Possession of valuable information does not guarantee that a third party will be able to profit from it. A subsequent bidder may free-ride on the information and complete a takeover, leaving the developer of the information with no return. The target firm itself will always benefit from the information. The greater certainty of profit increases the incentive of target firms to purchase information, all other things equal.

75. *Management Role*, *supra* note 14, at 1175. The loss is the opportunity cost of the resources used in resistance. If these resources were not consumed in the process of resisting, they would, presumably, be put to some productive use. Society as a whole loses when traders fight over the gains from trade. *Id.* at 1175 n.38. For demonstrations of this proposition, see Fama & Laffer, *Information and Capital Markets*, 44 J. Bus. 289 (1971); Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971).

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weight social costs can amount to millions of dollars.⁷⁶ These losses are reflected in lower values that bidders will offer when resistance is expected.

Greenmail, like other defensive tactics, does lower the amount bidders will offer for the target firm. In the numerical example, the \$200 greenmail payment to M lowered the bid T would make by \$2 per share. But this \$200 does not represent a real resource loss. Unlike other defensive tactics (e.g., litigation), which consume real resources, 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.⁷⁷ And even these are not deadweight social losses, but costs of producing and pricing a valuable resource: information. Thus, as with the free-rider argument, the general case against defensive tactics does not apply to greenmail; greenmail does not consume valuable resources.⁷⁸

76. *Management Role*, *supra* note 14, at 1175 n.39 (describing the costs of defensive litigation).

77. Nonrecipient shareholders may bring derivative suits against directors who pay greenmail, regardless of whether they benefit from such payments. These suits may represent opportunistic behavior on the part of shareholders or their attorneys. Opportunism is possible because a shareholder with a small stake in a firm has almost no incentive to consider the effect of the action on the other shareholders, who bear most of the cost. "If the action appears to be a positive net value project because of the prospect of attorneys' fees, it will be undertaken regardless of its effect on the value of the firm." Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, CORNELL L. REV. (forthcoming) (footnotes omitted). To the extent that such opportunistic behavior takes place, there is a loss of real resources connected with greenmail payments. This loss, however, is not caused by the greenmail payment itself, but by allowing the subsequent opportunistic litigation.

78. It is important to distinguish greenmail payments from the so-called "scorched earth" defensive tactics that at first glance might appear to involve simply a transfer rather than the consumption of real resources. A more careful look shows the real loss created by scorched earth tactics. Suppose a firm has a net present value of \$100,000,000. Of this value, \$50,000,000 is in the form of cash. The other \$50,000,000 represents the present value of the future income stream from the firm's manufacturing plant. If the firm pays out \$25,000,000 of its cash in greenmail, the value of the firm will drop to \$75,000,000. Subsequent bidders will still be willing to pay \$75,000,000 for the assets in addition to any increase in the value of the plant that might accrue from better management or economies of scale.

As the name implies, scorched earth defensive tactics typically involve actions by the incumbent management that make the target company substantially less attractive to potential bidders. A notable scorched earth tactic is the "lock-up" agreement. Under these agreements, the incumbent management enters into a contract with a friendly firm, often the target's investment banker. The contract provides that if the target firm is acquired, some asset of the target, such as the plant in the above example, may be acquired for a below-market price. Suppose the target enters into an option contract whereby it agrees to sell its plant to firm "X" for \$25,000,000, half its actual value, if more than 50 percent of its stock is acquired by a single firm. The firm's shares are now worth \$100,000,000 in the hands of the incumbent managers, but only \$75,000,000 in the hands of potential acquirors.

With such an agreement in place, there are two possible outcomes, each entailing a real economic loss. The scorched-earth agreement may deter a takeover, in which case the loss is the inability of a higher-valued user to acquire the firm. Or, the agreement may not deter a takeover, in which case the plant passes to a lower-valued user by definition.

B. *Greenmail in the Absence of a Credible Takeover Threat: The Role of Standstill Agreements*

Ignoring agency-cost problems for the moment, we have argued that greenmail may be viewed as compensation to the greenmailer for the information she has produced about the undervaluation of the target's resources. That information is valuable to the target firm and to other bidders, even if the greenmailer is not the highest-valuing user of the firm's resources. The question remains, why does a potential greenmailer take a position in the firm and threaten a takeover as a prelude to selling information? Assume that an outsider develops valuable information, but has no desire to initiate a takeover. The information is saleable, either to the firm itself or to potential third-party takeover bidders. One might wonder, in this case, why producers of information do not sell the information to one of these parties directly, without acquiring shares or threatening takeovers.

If a corporate outsider has valuable information, she would prefer to sell it directly to the firm if its value is greater than what she could expect from a takeover bid. There arise important bargaining problems, however, that might prevent M from selling the information she has discovered. The seller may be bluffing, as to either the value or even the existence of the information claimed. Would-be purchasers, either the undervalued firm itself or potential takeover bidders, find it difficult to value or verify the information unless it is revealed first.⁷⁹ If the information is revealed before the seller is compensated, nothing prevents the would-be purchaser from declining to purchase it, but using it anyway. Once the information is revealed, the producer of information effectively loses any enforceable property right in the information, and exposes herself to the same free-rider problems discussed above concerning an initial bid. By the same token, if the purchaser is asked to take it "on faith" that the information is really valuable, he exposes himself to being bluffed by someone who actually has no valuable information.

There is an alternative open to both buyers and sellers that would facilitate the efficient exchange of information. The developer of the information could indicate her good faith (the fact that she is not bluffing) by buying a bond that she would forfeit if she had acted in bad faith. Buying into the firm acts as the equivalent of a bond. The minority position works to bond the information seller in two ways. First, the minority

79. See Gilson, *supra* note 52, at 57 ("[T]he problem confronting the information producer [wishing to sell information] is verification; . . . in order for the information producer to secure any return on its investment in search, it must convince potential acquirers that its information is of a quality that warrants investment.").

holding entails an opportunity cost in the capital that, if her idea is without value, could have been invested more profitably elsewhere. Second, maintaining a substantial minority position has important effects on the investment portfolio of the information seller. Concentrating a significant percentage of the total portfolio in a single asset limits the minority shareholder's ability to diversify away asset-specific risk.⁸⁰ By showing that she is willing to incur these costs, the seller makes credible her claim of having valuable information.

In both respects, the minority equity position works like a surety bond to guarantee the quality of her information. The information may still not be revealed, however, until the shareholder receives a management position within the firm, which ensures that the firm will use her idea and compensate her for its value as the value of the stock rises. Additional compensation to the developer of the idea may come from the normal emoluments paid to directors and managers if she joins the firm in either or both of those capacities.

This is, in fact, what is accomplished by standstill agreements, a form of greenmail in which the substantial minority shareholder agrees to maintain a certain level of investment but also to limit her percentage ownership in the firm for a certain period of time. As Dann and DeAngelo note, standstill agreements frequently include representation on the board of directors for the minority shareholder.⁸¹ From the standpoint of the management of the target firm, having the greenmailer bond herself by entering into a long-term equity and/or employment relationship with the target firm mitigates the problem of bluffing. From the seller's standpoint, taking a position within the target firm allows the producer of information to reveal it without losing control of it.

This hypothesis concerning standstill agreements runs against the common perception that the agreements are simply ways to limit minority interference with the firm by freezing the minority's equity position at its current level.⁸² While that may be their function in some cases, standstill agreements can also work as a bonding mechanism permitting the transfer of information. If the bonding hypothesis explains at least some standstill agreements, we would expect to find situations in which standstill contracts were used to *increase* the size of the minority holding. If the size of

80. See generally R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 123-26 (2d ed. 1984) (explaining how diversification reduces risk).

81. Dann and DeAngelo, *supra* note 1, at 279.

82. See Bartlett and Andrews, *The Standstill Agreement: Legal and Business Considerations Underlying a Corporate Peace Treaty*, 62 B.U.L. REV. 143, 146 (1982); Gilson, *A Structural Approach To Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Note, *The Standstill Agreement: A Case of Illegal Vote Selling and a Breach of Fiduciary Duty*, 93 YALE L.J. 1093, 1096 (1984).

the minority's current stock holding is insufficient to bond her, the majority would insist on increasing the level of her equity. In fact, such equity-increasing standstill agreements are observed, even with corporate "raiders" whose involvement with the firm, one might have thought, majority shareholders would want to limit.⁸³

Standstill agreements as bonds have positive private and social costs, however, in the financial and human capital tied up in the minority's ownership of the firm. Particularly when outsiders specialize in the development of information, not ownership of firms, these bonding arrangements may be unnecessarily costly. The greenmailer may not want to tie up her human capital in the management of the target firm when her time is better spent uncovering and developing information about other undervalued firms that she can greenmail. The market provides another solution for these "repeat greenmailers": their reputation for developing reliable information itself acts as a bond to prospective purchasers of information.⁸⁴ Certain individuals, such as Victor Posner, Carl Icahn and Saul Steinberg are well-known greenmailers. When these people come to the management of a target firm and claim to have unearthed valuable information, they may demand an outright payment for the information that is not tied to any long-term employment contract. There is no danger to the target firm of a bluff from a greenmailer when the loss to the greenmailer's reputational capital from bluffing exceeds the gain from a one-time greenmail payment. Put another way, if a greenmailer is found to be bluffing, word will spread and her future demands for greenmail will go unheeded. One would predict, therefore, that greenmailers with substantial investments in brand-name capital would more frequently be able to sell their shares outright rather than "post bond" by entering into standstill agreements.

83. See, e.g., Guyon, *Frank B. Hall Stake to Be Lifted By Saul Steinberg*, Wall St. J., Dec. 20, 1984, at 10, col. 3. Steinberg, a well known greenmailer, signed a standstill agreement with Frank B. Hall & Co., under which Steinberg agreed to increase his holding of Hall stock from 9 to 20 percent and then to join the board of directors.

When the optimal size of the bond (represented by the opportunity cost of the minority shareholder's investment and the decreased portfolio diversification of a large holding of target firm stock) is large, an interesting problem may arise. A large minority holding may represent de facto control of a corporation if the ownership of the rest of the shares is widely dispersed. If this is undesirable (e.g., if neither the minority nor the majority desire that the minority control operation of the firm), the standstill agreement may limit the voting independence of the minority shareholder. In the Texaco-Bass Brothers agreement, see *supra* note 5, for example, part of Bass Brothers' greenmail was in the form of Texaco voting preferred stock, which Bass Brothers agreed to vote as instructed by the Texaco board.

84. Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 616 (1981); Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27 (1980). See Gilson, *supra* note 52, at 58 ("[O]ne would expect information producers who hope to sell information to make substantial investments in reputation, thereby both signaling that their product is of a quality to warrant repeat purchases and putting their investment in reputation at risk should the information prove to be inaccurate.").

Thus, the precise form of a particular greenmail payment reflects the risk that the buyer will not actually receive useful information. Our theory suggests that sell-and-leave greenmail payments (negotiated stock repurchases) will be made more often to a well-known greenmailer whose word can be trusted. Others without reputations for developing valuable information, who claim to hold valuable information, will be required to hold their positions in the firm—"stand still"—as a bond that they do in fact possess such information.⁸⁵

II. OBJECTIONS TO GREENMAIL

In the above model, 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 offerors. Nevertheless, greenmail has been heavily criticized. The attacks on greenmail can be grouped into two categories. The first attack is the charge that managements pay greenmail only to protect their jobs (the agency-cost objection). The second attack is the claim that negotiated repurchases treat majority shareholders inequitably, since shareholders do not share the greenmail premium equally (the unfairness objection).⁸⁶ In this Section we thus relax our as-

85. The problems of information valuation and verification thus could explain why both incumbent majority buyers and minority sellers of information would agree to have the minority hold shares in a standstill agreement. But they do not explain why standstill agreements typically set an upper limit on the permissible percentage of minority equity ownership. Rational majority buyers of information might insist that the seller agree to a limit on the number of shares she can acquire to avoid the possibility of a seller's subsequent breach of contract.

Even if managers pay greenmail to M to facilitate a bid by third parties, M may still have the incentive to enter a bid before any T. Moreover, M still has the information advantage that may permit her to complete a bid before other parties can put together the higher bid that greenmail supposedly was to secure. There is no reason that M could not take the greenmail, supposedly to facilitate T's bid, and then complete a takeover herself. The only way to guarantee that the maximum benefits of a higher bid accrue to target-firm shareholders is to freeze M's equity position, as the "standstill" part of the greenmail agreement does.

Incumbent shareholders could allow M to reenter the market and still potentially gain from paying greenmail if M were restricted to purchasing at the same price that T was expected to offer. But, of course, target-firm shareholders may not know what T's maximum price is, and so would be unwilling to stipulate a price for M that risks being low.

86. Besides the agency-cost and the unfairness objections developed at some length here, it is sometimes alleged that greenmailers desire to "raid" or "loot" the assets of the target firm should they gain control. "Although such allegations are often levied against [greenmailers], there seldom is a precise definition of corporate raiding." Holderness & Sheehan, *Raiders or Saviors?: The Evidence on Six Controversial Investors*, J. FIN. ECON. (forthcoming). When Foremost-McKesson responded to Victor Posner's acquisition of its stock by filing suit in 1981, it alleged that Posner had "taken over and looted at least eight corporations" previously, and claimed that his goal was to "prey upon and defraud" shareholders by a "corruptly conceived and maliciously executed strategy." Montgomery, *Meet Victor Posner: Music Virtuoso Who Plays the Market*, Wall St. J., June 23, 1981, at 1, col. 4. "Fraud" and "corruption," however, were not exactly defined. See also *Dan River, Inc. v. Icahn*, 701 F.2d 278, 283 (4th Cir. 1983) (company feared greenmailer would "embark upon a course of extraordinary transactions which will dismantle the company as it now exists").

Even if "looting" (however defined) is truly a problem, its occurrence could only justify the payment of greenmail. If raiders can "loot" a firm once control is acquired, greenmail payments are

sumption that management always acts in shareholders' interest, and ask whether agency costs or equity concerns would lead shareholders to prefer restrictions on greenmail.

A. *The Agency-Cost Objection*

1. *Theory*

The most common objection to greenmail (and indeed the source of the appellation itself) is that such payments are akin to extortion. According

rational and beneficial from the shareholder's perspective as long as they do not exceed the expected losses from "looting." Greenmail to fend off "looters" would be no more reprehensible than a burglar-alarm system in a high-crime area—a cost to the firm, to be sure, but one justified in avoiding even greater expected crime losses. Certainly, ending greenmail would not end whatever incentives exist for fraud and corruption. Firms unable to pay greenmail might well find themselves facing more actual looting than firms that can pay. If firms can avoid detrimental "looting" by paying greenmail, it is in the best interests of the shareholders to pay it.

At times, however, incumbent management may pay greenmail not because it is concerned with looting but because it is concerned with a more subtle problem—disruption. A "looter" actually steals from the corporation it controls. A "disruptor" does not steal, but causes the value of the firm's shares to decline in order to be bought off with greenmail. Disruption takes a variety of forms, from simply wasting management's time at board meetings to making bad business decisions that decrease the earnings of the firm. From an economic standpoint, a raider who threatens to acquire a large minority share in a firm and use the resulting influence to disrupt the firm's operations is no different from a looter. Both reduce the value of the firm without benefiting the shareholders. But disruption, unlike looting, does not even transfer wealth to the raider.

From a legal perspective, disruptors pose a far more serious problem than looters because they are likely to be judged by a different and more lenient legal standard. Corporate officers and directors owe shareholders two sorts of fiduciary duties. The first is a duty of care, which requires that they exercise a minimum level of skill and judgment in operating the company. Officers and directors also owe shareholders a duty of loyalty, which requires that they put the interests of the shareholders ahead of their own pecuniary interests.

Looters patently violate their fiduciary duty of loyalty to the firm they loot. By contrast, the behavior of disruptors, because their activities can be masked under a guise of trying to improve the operation of the corporation, and because they do not profit directly from disrupting the firm's operations, will be judged under the far more lenient standard of the duty of care. See Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 927 (1983) (distinguishing duty of care from duty of loyalty). In duty of care cases, courts typically apply the business judgment rule. Under this rule, a board of directors "enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose." ECONOMIC REPORT OF THE PRESIDENT, *supra* note 9, at 214 (footnote omitted). Because the business judgment rule insulates managers and directors from liability in duty of care cases, disruptors have little to fear in the way of legal sanctions. See Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968) (finding cases that impose liability for violating duty of care is akin to finding "a very small number of needles in a very large haystack"). Thus, shareholders have even stronger reasons to pay greenmail to eliminate disruptors than looters. Not only do disruptors decrease the value of the firm, but the legal system is particularly ill-equipped to deal with disruptors.

An important distinction between looting and disrupting is that looters must gain control of a firm in order to loot it. Disruptors can cause harm merely by acquiring a large minority interest. Firms that fear disruptors may decide to amend their charters to forbid the payment of greenmail. From a game-theoretic perspective, this will eliminate the ability of a disruptor to engage in opportunistic behavior. If a firm outlawed greenmail, a disruptor could not demand a side payment in exchange for an agreement not to disrupt the firm, since the firm would be unable to succumb to the threat even if it wanted to.

to this theory, a raider first acquires a significant interest in a firm, and then, in effect, says to incumbent management, "buy out my interest at a premium or I will acquire your firm and fire you." The objection stems from the Berle-Means paradigm of "separation of ownership and control" in the modern corporation,⁸⁷ or from what Jensen and Meckling have analyzed more carefully as the problem of "agency costs" within large firms.⁸⁸ A manager, as the shareholders' agent, should use corporate assets only to increase the value of the firm. In reality, however, with positive shareholder monitoring costs, a manager concerned about his job may be able to act to protect his tenure at shareholders' expense. 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.

The agency-cost objection applies to defensive tactics generally, but has been identified as making greenmail (including standstill agreements) particularly undesirable:

The potential personal costs associated with a change in corporate control provide incumbent management with the incentive to use corporate resources to blunt a takeover threat Consequently, in at least some cases, a substantial stockholder with a credible threat is able to extract [greenmail] from management in exchange for a reduced takeover threat.⁸⁹

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

87. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119-25 (1933).

88. Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Jensen and Meckling define and describe the agency relationship as:

a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal.

Id. at 308. Because of the tendency of the agent to act in ways that are not in the best interests of the principal, both the principal and the agent have incentives to incur costs to reduce the incidence of such behavior. These costs, along with any residual cost from undesirable behavior that is not deterred, are the costs of a principal-agent relationship.

89. Dann & DeAngelo, *supra* note 1, at 278. Dann and DeAngelo refer to this agency-cost explanation of greenmail as the "managerial entrenchment hypothesis." *Id.* at 279. More popular sources make the same point. "[The greenmail] phenomenon is seen as top executives using small shareholders' money to buy out larger ones in order to protect the executives' jobs, and doing so in a way that lowers the value of the small shareholders' stock." Kirkland, *supra* note 2, at 152.

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 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."⁹⁰ 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.

Market correctives inhibit at least some agency-cost problems in the firm. The "market for managers" penalizes management teams who try to advance their own interests at shareholders' expense.⁹¹ Shareholders have also demonstrated the ability in other contexts to perceive the agency-cost dilemmas inherent in managerial decisions that affect managers' job tenure, and to mitigate them by charter amendments.⁹² In light of all this, it is unclear why supposedly disadvantaged shareholders have not been galvanized by the recent wave of greenmail payments to protect themselves via corporate charter amendments.⁹³ While these amendments are them-

90. Dann & DeAngelo, *supra* note 1, at 276.

91. The theory of a "market for managers" goes back at least to Alchian, *Corporate Management and Property Rights*, in *ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 337, 343 (H. Manne ed. 1969). The theory was formalized and extended in Fama, *Agency Problems and the Theory of the Firm*, 88 *J. POL. ECON.* 288, 291-95 (1980). We do not suggest, of course, that the market for managers is "perfect" in some idealized way, nor that it alone operates to monitor management. We note only that "[a]n important premise of corporate finance theory is that markets discipline managers to maximize all stockholders' wealth. Competitive forces in two markets, the market for corporate control and the market for managerial labor services, are widely viewed as providing complementary enforcement of the stockholder wealth maximization rule." Dann & DeAngelo, *supra* note 1, at 275.

For empirical evidence on one way the market for managers works, see Faith, Higgins & Tollison, *Managerial Rents and Outside Recruitment in the Coasean Firm*, 74 *AM. ECON. REV.* 660 (1984) (firms reduce agency costs by increasing turnover of managers and paying higher salaries as turnover rises).

92. The adoption of "golden parachute" agreements by shareholders as a means of aligning the interests of managers more closely with their own illustrates the ability of shareholders to react effectively to the agency-cost problems described above. See W. Carney, *Golden Parachute Agreements: Agency Costs, Opportunism and a New Approach to Consideration* (1985) (unpublished manuscript) (on file with the authors); see also W. Carney, *Pols Poking Holes in Golden Parachutes*, *Wall St. J.*, Apr. 16, 1984, at 32, col. 3. It is noteworthy that shareholders of half the major corporations in this country have written "golden parachute" provisions into their charters in the past ten years. W. Carney, *Golden Parachute Agreements: Agency Costs, Opportunism and a New Approach to Consideration*, *supra*, at 1 & n.3. Event studies show that adoption of such provisions causes a firm's stock to rise. Lambert & Larcker, *Golden Parachutes, Executive Decision-Making, and Shareholder Wealth*, *J. ACGT. & ECON.* (forthcoming).

93. "Any board of directors can eliminate greenmail . . . through an amendment to the corporate charter . . ." Siegel, *supra* note 10, at 158.

If they wanted to, executives could put through a change in the corporate charter to forbid stock repurchases at a premium unless they were part of a general tender offer. Mead Corp., a \$2.4-billion-a-year forest products company, has had just such a provision in its bylaws for more than 50 years. Why don't more managements follow Mead's lead?

selves costly, the fact that some firms have enacted charter provisions to eliminate greenmail demonstrates that if the agency-cost problem exists, it is not intractable.⁹⁴ Moreover, the costs of writing anti-greenmail provisions into the charters of newly forming corporations are virtually nil. The agency-cost hypothesis is at odds with the general failure of new firms to write such provisions into their charters.

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 (as other tactics such as shark repellents do). Rather, they *encourage* such bids by signaling to the market that the firm has been perceived as undervalued by an imminent tender offeror 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.⁹⁵

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.

Paying greenmail is doomed to fail as other greenmailers will come along and demand similar payments.⁹⁶ Unless rather restrictive assump-

Kirkland, *supra* note 2, at 153.

94. International Minerals & Chemicals, and Perkins Elmer, for example, have already adopted charter amendments that prohibit targeted share repurchases unless approved by a majority of the disinterested shareholders or a majority of directors who are not affiliated with the larger holder. See Siegel, *supra* note 10, at 157, 158.

95. Thus the idea that a firm will pay greenmail to avoid being taken over is akin to the idea that firms will engage in price cutting (predatory pricing) in order to drive rivals out of business. Both ideas require the firm to incur losses, a process that cannot continue forever. See R. BORK, *THE ANTITRUST PARADOX* 149-55 (1978). That a firm can force rivals out of business and then reap monopoly profits suffers from several flaws, not the least of which is that once the predator has forced its rivals out and raised its prices again, new rivals can enter the market. *Id.* at 153. A similar argument applies to greenmail. Once greenmail is paid, there are no barriers to additional firms purchasing shares in the firm in order to receive such payments themselves.

96. It is conceivable that incumbent managements realize that greenmail is bound to be ineffective, but pay it anyway in order to "buy time" to install other, more generally applicable, defensive devices. If this were the case, we would expect firms that have paid greenmail to begin girding immediately

tions are made about the greenmail process, management teams paying greenmail to protect their jobs are at best myopic, and perhaps irrational.⁹⁷

Put another way, greenmail differs from the defensive tactics described earlier in that it is firm-specific. It stops only one particular firm from acquiring control of its target. Other defensive tactics (i.e., locating a white knight, selling off key assets, installing shark-repellent amendments) apply against any and all potential acquirors. Greenmail does not; it signals "open season" for successive waves of purchasers to acquire substantial minority blocks of shares in order to be bought off.

Finally, even if it is assumed that managers are truly able at times to advance their tenure at the expense of their principals' wealth, it does not follow that shareholders would necessarily want to strip managers of the authority to pay greenmail. In the situations identified in Section I above—where a higher takeover bid can be expected if the minority bidder is bought out, or where the minority owner has useful information to sell to the firm—the incentives of both shareholders and the managers run in the same direction. Admittedly, shareholders and managers might want to pay greenmail for quite different reasons. But the fact that managers do what shareholders want for selfish reasons is of no concern to shareholders.⁹⁸ Indeed, successful firms are precisely those that align shareholder and manager incentives. Managers may do the right things (from the shareholders' perspective) for the wrong reasons.⁹⁹

We by no means deny that managers may buy off minority shareholders in some instances where the majority would prefer that greenmail not

for another takeover battle by, for example, selling off assets, installing shark-repellent amendments, or entering into "lock-up" contracts. Casual empiricism suggests that this typically does not happen, and we are unaware of any systematic evidence that this activity occurs in the wake of greenmail payments.

97. See Toy, *supra* note 10, at 83 (paying greenmail of "dubious value"). If greenmail payments were followed by the installation of other defensive devices, managers could still argue that shareholder wealth is increased since these devices mitigate the prisoner's dilemma that target shareholders face when confronted with a tender offer. See *supra* text accompanying notes 32-41. Shareholders, however, should ask why such defensive devices were not installed in a more timely way.

98. See generally Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211, 213 (1950) ("It does not matter through what process of reasoning or motivation such success [i.e., profitability] was achieved. The fact of its accomplishment is sufficient. This is the criterion by which the economic system selects [its] survivors . . .").

99. See *supra* note 92, for a discussion of golden parachutes. Jarrell's evidence on litigation defenses to takeover bids is also instructive. Jarrell, *supra* note 47, at 175. Management's decision to litigate in order to block a takeover bid prolongs their job tenure. But Jarrell finds even when litigation is successful, most firms are eventually taken over, but at substantial premiums above the initial bid price. Some firms are not taken over, but the gains in auctions and higher premiums produced by litigation exceed the losses to those firms that do not get attractive second bids. *Ex ante*, then, wealth-maximizing shareholders would want management to litigate—as would tenure-maximizing managers themselves. This does not mean, of course, that litigation is economically efficient. It may simply be a way of free-riding on the information developed by the initial bidder whose offer is defeated by litigation.

be paid. But given that managerial discretion to make such payments can benefit shareholders, the existence of agency costs does not mean that shareholders will necessarily want to deprive managers of the ability to pay greenmail. The questions are empirical ones. Are managers' decisions consistent with shareholders' interests often enough that, on net, shareholders are still better off with the possibility of greenmail being paid, despite the potential for agency costs? Can markets discriminate between "good" and "bad" greenmail, such that some firms may prefer to allow greenmail even when others do not?¹⁰⁰

2. *Empirical Evidence*

The ultimate test of the agency-cost objection to greenmail lies in the stock performance of the firm paying the greenmail. If the payment of greenmail is not in the best interests of a firm's shareholders, the value of the firm (as measured by the price of its stock) should decline in the wake of such payments.

This hypothesis, and the agency-cost model in general, initially seemed confirmed by the two early empirical studies of greenmail, those of Dann and DeAngelo and of Bradley and Wakeman.¹⁰¹ These studies compared the stock prices of firms paying greenmail at two points in time, immediately before and immediately after the greenmail payment. Both studies found statistically significant declines (up to four percent) in share prices when firms paid greenmail.¹⁰²

The inferences to be drawn from such results are quite ambiguous, as

100. Other empirically testable implications are worth considering. Is greenmail paid even when management is protected by golden parachutes? If so, this would support the shareholder-welfare hypothesis outlined in this Article. Are firms more likely to pay greenmail as the number of inside directors rises? If not, this would also support the shareholder-welfare hypothesis.

101. Dann & DeAngelo, *supra* note 1; Bradley & Wakeman, *The Wealth Effects of Targeted Share Repurchases*, 11 J. FIN. ECON. 301 (1983).

102. Dann and DeAngelo found that standstill agreements caused a statistically significant decline of over four percent in repurchasing firms' share prices, but obtained no conclusive results for negotiated stock repurchases. Dann & DeAngelo, *supra* note 1, at 290, 293-95. In fact, Dann and DeAngelo found no significant difference between the wealth increase of the selling shareholder and the wealth decrease of nonparticipating shareholders in the purchasing firm. *Id.* at 296-97. Greenmail, that is, appeared to be purely a transfer payment with no additional efficiency implications, a result that they note is at odds with "the prediction of the entrenchment hypothesis that total equity value will decline at the time of a negotiated premium repurchase." *Id.* at 297. Dann and DeAngelo note, however, that their statistical tests are biased against a finding of any change. *Id.* at 297-98.

Bradley and Wakeman found that greenmail significantly reduced the wealth of repurchasing firms' nonparticipating shareholders by up to three percent. Bradley & Wakeman, *supra* note 101, at 307. This was true whether or not the repurchasing firm paid greenmail in the face of a threatened merger. The distinction is important, of course, since firms threatened with takeovers would have an increased incentive to pay greenmail, and indeed Bradley and Wakeman find that the size of the greenmail payment and the amount of the wealth decrease are greater for merger-related greenmail payments. *Id.* at 313-15.

the authors themselves admit.¹⁰³ Moreover, the model developed in Section I suggests that these two studies take an overly static view of greenmail. Whatever greenmail's effect on firm wealth when it is paid, one must also take account of the effects of the first half of the greenmail process—the initial stock purchase by the minority holder that signals the location of a possibly undervalued firm. If share prices rose when the future greenmailer initially purchased her holdings and did not fall by at least as much when greenmail was paid, majority shareholders would still be better off on net.¹⁰⁴

This is precisely what more recent studies have found. Unlike the earliest studies of greenmail, four subsequent studies (Mikkelson-Ruback, Holderness-Sheehan, Poulsen, and Jarrell-Ryngaert)¹⁰⁵ analyze the entire greenmail process, not just a fraction of it. These studies evaluate greenmail by including the effect on share prices when greenmailers initially buy into a firm along with the effect when the greenmail payment is actually made.¹⁰⁶

Consistent with the first two studies, the subsequent studies find that a standstill or greenmail agreement causes the paying firm to incur a statistically significant loss at the time the agreements are announced. But the studies found this loss to be less than the price increase that occurred when the minority initially purchased its shares. For example, the positive

103. Dann and DeAngelo concluded that there was "at best, weak support" for the agency-cost or managerial-entrenchment hypothesis of greenmail. Dann & DeAngelo, *supra* note 1, at 296. Similarly, Bradley and Wakeman, while favoring the managerial-entrenchment hypothesis, admit that the evidence on nonmerger repurchasing firms is only "weak" support for that hypothesis, and that the more probative evidence on merger-related greenmail is even "less clear." Bradley & Wakeman, *supra* note 101, at 313. The difficulty with the latter evidence is that the negative wealth effect may simply reflect the information that a merger or takeover is simply not in the parties' interest, rather than evidence of management deflecting a bid advantageous to shareholders. While the results

indicate that a share repurchase is a wealth-reducing event for non-participating shareholders, they do not imply malfeasance on the part of the repurchasing firm's managers. . . . The fall in the price of the shares of the repurchasing firm may simply reflect the discovery by the selling firm that the repurchasing firm does not, after all, possess the specialized resource that is necessary for a profitable acquisition.

Id. at 307, 309.

104. Under such circumstances a tender offer aborted by greenmail would be better than no tender offer at all. Since prohibiting the payment of greenmail decreases the likelihood of tender offers, *see supra* text accompanying note 50, shareholders may favor greenmail payments.

105. Mikkelson & Ruback, *supra* note 21; Holderness & Sheehan, *supra* note 86; A. Poulsen, Market Relation to "Corporate Raiders" as Individuals (1984) (unpublished manuscript) (on file with the authors); Office of the Chief Economist (G. Jarrell & M. Ryngaert), SEC Information Memorandum OCE 84-10 on the Impact of Targeted Share Repurchases on Stock Prices (Sept. 4, 1984) (on file with the authors) [hereinafter cited as Office of the Chief Economist].

106. Mikkelson and Ruback stress that simply analyzing the immediate effect of greenmail on stock prices in itself cannot answer the question of greenmail's ultimate effect on shareholder wealth: "The profitability of the various outcomes is measured by examining the share price behavior of the acquiring and target firm throughout the entire investment process, which includes the announcement of the initial investment, the outcome [e.g., greenmail] announcement, and any important intervening events." Mikkelson & Ruback, *supra* note 21, at 2.

price effect found for the Mikkelson-Ruback sample when greenmailers buy into a firm is over 4%, outweighing the negative effect of greenmail itself and leaving a statistically significant gain of almost 2% from the overall purchase-to-greenmail sequence of events.¹⁰⁷

The only study of the entire sequence concluding that greenmail is on net deleterious to shareholder-welfare is that of Jarrell and Ryngaert.¹⁰⁸ Like the Mikkelson-Ruback and Holderness-Sheehan studies, the Jarrell-Ryngaert work finds that the initial stock-price increase (9.7%) when the greenmailer first purchased stock was greater than the price drop (5.2%) when greenmail was later paid.¹⁰⁹ But Jarrell and Ryngaert nevertheless conclude that greenmail leaves repurchasing firms worse off, because of events in the “interim period” allegedly associated with the greenmail sequence; the interim events were found to decrease repurchasing firms’ wealth by an additional 7.1%.¹¹⁰ Overall, the purchase-to-greenmail sequence, including the large loss attributed to interim events, decreased repurchasing firms’ value by almost 4%.¹¹¹

The key to the Jarrell-Ryngaert results, then, is this extraordinary loss ascribed to interim events. Both the Mikkelson-Ruback and Holderness-Sheehan studies attempted to control for events that might have affected

107. *Id.* at 25 (Table 6). Mikkelson and Ruback found it striking “that when the final outcome of an investment is a standstill or repurchase agreement with the target firm, the *total* return earned by target shareholders is positive, even though the price effect of the standstill or repurchase announcement is negative.” *Id.* at 3. Holderness and Sheehan use methodology similar to that in Mikkelson-Ruback to examine the share price effects when six particularly well-known investors (Carl Icahn, Irwin Jacobs, Carl Lindner, David Murdock, Victor Posner and the late Charles Bluhdorn) bought into a firm and later accept greenmail. Holderness & Sheehan, *supra* note 86. Their findings replicate those of Mikkelson and Ruback: even allowing for a negative wealth effect of the greenmail payment itself, the net effect of the greenmailer’s buying into the firm is significant and even more positive, over 3%. *Id.* at 25 (Table VI).

Poulsen used the same model to examine the wealth effects on firms of investments made by three well known “raiders”: Carl Icahn, Victor Posner, and Saul Steinberg. Poulsen, *supra* note 105. Her findings as to Icahn and Posner parallel those of the earlier Mikkelson-Ruback and Holderness-Sheehan studies. Even with greenmail being paid at the end, target firms benefit from the greenmailer’s acquisition of shares because of the significant price increase when Icahn and Posner initially buy into these firms (3.5 and over 4%, respectively). *Id.* at 16-18 (Table 3). But her findings as to Steinberg are the opposite. Firms are on net worse off when he buys into a firm and then either takes greenmail or simply sells his shares.

The evidence of Poulsen and of Holderness and Sheehan is important, demonstrating the different reactions that shareholders register in the market to the activities of different greenmailers. Discussing her finding that Saul Steinberg’s activities have decreased target firm returns, Poulsen cautions: “[T]hese results indicate that the market anticipates well the probable outcome related to each ‘corporate raider’ on an individual basis The lack of similarity between reaction to Icahn and Posner acquisitions and reaction to Steinberg acquisitions suggests that market participants are not reacting blindly to 13D filings.” *Id.* at 18-20. Such evidence of individual-specific market reaction supports this Article’s theory of the existence of greenmailers’ reputation capital. *See supra* text accompanying note 84.

108. Office of the Chief Economist, *supra* note 105.

109. *Id.* at 7 (Table 1).

110. *Id.*

111. *Id.*

share prices during the repurchase-to-greenmail period by locating significant intermediate events concerning each stock, and measuring their effects individually—stock by stock and event by event.¹¹² Unlike the other studies, Jarrell and Ryngaert did not work with specific events in their intermediate period estimates. Rather, they simply treated the entire period between initial purchase and greenmail as an “event” itself. There are serious methodological objections to this technique. Most obviously, if the intermediate period between initial purchase and acceptance of greenmail is lengthy, the supposed “adjustment” for other events supplying information about the minority owner’s activities will in fact measure the effects of other changes occurring during that time that have nothing to do with the minority investment.¹¹³ The distortion created by this sort of random “noise” increases with the length of the period treated as a single event.

The average period of the intermediate “event” used by Jarrell and Ryngaert (i.e., the average length between the initial acquisition and the ultimate greenmail payment) was 280 trading days—well over a full year.¹¹⁴ As it is solely the changes in stock prices during this intermediate period that lead Jarrell and Ryngaert to conclude that greenmail on the whole hurts firms, one cannot dismiss the likelihood that changes other than those related to greenmail occurring during the extraordinarily long “intermediate” period are responsible for the decline in firm share prices. The methodology used in the studies of Mikkelsen-Ruback, Holderness-Sheehan and Poulsen gives them more credence.

Admittedly, the more reliable studies’ result—that the losses from

112. “Significant intermediate events are those instances . . . where the investor revealed significant information about his future intention with respect to the target firm, or when the target firm’s management revealed significant information on how they planned to respond to the investor.” Holderness & Sheehan, *supra* note 86, at 23. Such specific events might include an announcement that the minority investor had demanded that the firm either repurchase his shares or face a proxy fight, *id.* at 23–24, a tender or merger offer from the acquiring firm, a takeover offer by another firm, the acquisition of additional shares by the acquiring firm, or opposition to the investment by management of the target firm. Mikkelsen & Ruback, *supra* note 21, at 20. The effect of the intermediate events was measured within days of the disclosure of the intermediate event. Both the Mikkelsen-Ruback and the Holderness-Sheehan studies conclude that these carefully modelled intermediate events had no significant effects on the positive wealth effect due to greenmailers’ entry into and exit from the repurchasing firms.

113. Jarrell and Ryngaert are aware of this problem of course. *See* Office of the Chief Economist, *supra* note 105, at 5.

114. Office of the Chief Economist, *supra* note 105, at 8. The maximum length of the interim period for all cases in the Jarrell and Ryngaert study is not indicated, but the extent of the distortion can be inferred from Poulsen’s finding that the *average* time between acquisition and resale for one greenmailer, Victor Posner, is 399 trading days. Poulsen, *supra* note 105, at 10. For some events studied by Jarrell and Ryngaert, then, the “intermediate events” attributed to greenmail must have been all events affecting the particular stock’s price, from whatever source, for a period of some two years. By contrast, in measuring the effects of specific intermediate event, Mikkelsen and Ruback used a two-day adjustment period to the disclosure of new information. Mikkelsen & Ruback, *supra* note 21, at 24, 25 (Table 8).

greenmail are less than the gains from the greenmailer's initial stock purchase—does not fully support either the agency-cost or the shareholder-welfare hypothesis. Under the agency-cost hypothesis, the post-greenmail value of the firm should fall below even its level prior to the minority stock purchase. The evidence is to the contrary: firm values are greater after the purchase-to-greenmail process is completed. But under the shareholder-welfare hypothesis the firm's value should rise upon payment of the greenmail even though it already rose at the time of the initial acquisition. The evidence indicates that normally this also does not occur.

This tension between theory and evidence is resolved when one realizes that the studies report *average* price changes. If we observe both types of greenmail (agency-cost and shareholder-welfare) in the real world, one would expect the average price change to be in-between that predicted by the two theories.

In fact, this conclusion—that greenmail payments are made at times for the agency-cost reasons and at times to enhance shareholder welfare—is strikingly supported by the data. For example, Mikkelson-Ruback found that for 44% of the repurchasing firms, the payment of greenmail was associated with a *positive* change in shareholder returns (in *addition* to the earlier wealth increases when the greenmailer acquired her original shares).¹¹⁵ The existence of so many positively valued payments of greenmail indicates that in at least a non-negligible proportion of the cases, greenmail benefits the paying firm's shareholders. By paying greenmail, management can abort a takeover and dilute the assets per share, yet have the stock price rise.

While the empirical studies of greenmail are far from conclusive, they force both sides in the greenmail debate to confront the question of exactly how firms can gain from negotiated stock repurchases. The Mikkelson-Ruback, Holderness-Sheehan, and Poulsen papers only measure greenmail's effects; none attempts to explain why greenmail payments would increase firms' values.¹¹⁶ In fact, Ruback himself has admitted to being

115. Mikkelson & Ruback, *supra* note 21, at 25 (Table 6). In the Dann and DeAngelo study 28% of standstill agreements and 40% of greenmail agreements were positively valued. Dann & DeAngelo, *supra* note 1, at 292, 295. Similarly, in Bradley and Wakeman's sample 35% of the greenmail agreements raised the stock price. Bradley & Wakeman, *supra* note 101, at 312. None of the studies discusses how many of the positively valued events were statistically significant.

116. Mikkelson and Ruback do not speculate about why the net result of greenmail is positive for nonparticipating shareholders, nor about why firms pay greenmail. But one additional finding of their study is of interest. Mikkelson and Ruback's sample included 479 firms that made 13D filings, sorted according to the purpose stated for the initial investment when the Schedule 13D filing was made. Of their entire sample, 28% of the filings listed the purpose of the initial acquisition as a takeover attempt, including 73% of those who actually were successful in completing a takeover. If greenmail were an attempt to elicit payments from entrenched management in exchange for their jobs, one would think that a relatively high proportion of those ultimately receiving greenmail would indicate

“shocked” by his findings.¹¹⁷ Until now, no systematic theoretical analysis of greenmail has been presented. With no model of greenmail as a guide, the statistical inquiries have failed to distinguish between what may be separate types of greenmail. Until greenmail is better understood, regulating or banning it seems premature.¹¹⁸

B. *The Unfairness Argument*

A second objection to corporate greenmail payments concerns the way in which greenmailers 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”² has 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. Substantial minority blocks of stock should be acquirable, it is argued, only through tender offers to all shareholders. English courts apply this rule whenever 30% of a firm’s shares are acquired.¹¹⁹ A tender offer would reveal the attempt to acquire de facto control, raising the price to the acquirer, and would allow all shareholders to tender at the higher price, and so would be “fairer.”¹²⁰

This argument seems to misinterpret the reasons why greenmail is paid. As discussed earlier, shareholders may *want* to pay greenmail *before* control is acquired by the greenmailer, in order to facilitate acquisition of control by a higher-valuing third party.¹²¹ The firm, in effect, pays for information developed by the greenmailer, whether or not the minority block is substantial enough to constitute de facto control. Indeed, the actions of the best known corporate “raiders” suggest that actual manage-

that the purpose of their initial acquisition was a takeover. In fact, the Mikkelson-Ruback data show that *none* of the 39 firms that later took greenmail payments or accepted standstill offers from repurchasing firms indicated that a takeover was the purpose of the acquisition. Mikkelson & Ruback, *supra* note 21, at 8 (Table 1).

117. Ruback is quoted in Kirkland, *supra* note 2, at 154.

118. Even Dann and DeAngelo, *supra* note 1, who embrace the agency-cost interpretation of greenmail, admit that “at this stage of development, the managerial entrenchment hypothesis, if correct, does not imply that negotiated settlements of control contests should be prohibited on grounds of economic efficiency.” *Id.* at 280 n.8.

119. DeMott, *Current Issues in Tender Offer Regulation: Lessons from the British*, 58 N.Y.U. L. REV. 945, 960 (1983) (citing Council for the Securities Industry, *The City Code on Takeovers and Mergers*, Rule 34 (5th rev. ed. 1981)).

120. For an example of this view, see Blustein, *Let Us Now Consider Carl Icahn*, Wall St. J., Dec. 22, 1982, at 14, col. 3.

121. Once control has passed to the greenmailer, of course, any share repurchases negotiated at a premium solely with the new majority owner will not be considered greenmail, but pure self-dealing. See *supra* note 86 (discussing legal treatment of self-dealing transactions).

ment of the firm whose shares they acquire is the last thing on their minds.

Even were it true that greenmailers always seek to acquire and resell de facto control of the firm (rather than sometimes to sell information about the firm, as discussed above), it does not follow that the value of control should be spread among all shareholders. The unfairness argument confuses fairness *ex post*, after the greenmailer has acquired his shares, with genuine fairness *ex ante*. *Ex ante*, as Easterbrook and Fischel have shown, shareholders would voluntarily agree to a rule “that those who produce a gain should be allowed to keep it, subject to the constraint that other parties to the transaction be at least as well off as before the transaction.”¹²² Shareholders themselves would be free-riding on the gains produced by the greenmailer. Forced sharing of gains that the greenmailer alone has produced only reduces the overall size of the gains for all. Firms that gain when a greenmailer buys in would find that forced sharing of the gains reduces the likelihood of the minority bidder acquiring an interest in the first place. Thus, behind the *ex ante* “veil of ignorance,” shareholders would not want an equal sharing of gains.

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 (under the argument) expect to be treated the same, and to do otherwise would be “unfair.”¹²³ The common law, however, has never required that corporate stock repurchases be made on equal terms or in equal amounts from all shareholders.¹²⁴ And again, 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.

122. Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 703–04 (1982) (equating equal treatment with fair treatment confuses contracts that maximize wealth *ex ante* and legal rules that redistribute wealth *ex post*) [hereinafter cited as *Control Transactions*]; see also Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 323–30 (refuting argument that fairness requires equal treatment); Fischel, *Efficient Capital Market Theory, The Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 10–15 (1978) (requiring equality of treatment in tender offers may undermine value of property rights in information).

123. This argument seems to be more popular in the academy than in the courts. See *Control Transactions*, *supra* note 122, at 703.

124. The common law limitations on the power of a corporation to purchase its own stock were minimal. CARY & EISENBERG, *supra* note 36, at 1424. A corporation “was permitted to repurchase its own stock if the repurchase did not render the corporation insolvent, was made ‘in good faith,’ and was ‘without prejudice to the rights of other stockholders or creditors.’” *Id.* But see *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975) (overruling earlier cases and requiring corporation to allow all shareholders to sell shares ratably to firm at same price as that of any shares to be repurchased).

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 greenmailer is forced to share her gains.

When a firm acquires its own stock through a greenmail payment, the price paid must be segregated into its two components. One is payment for the stock, and the other payment for producing valuable information. Payment of greenmail does not involve unequal compensation if the greenmailer produces something of value to the firm that other shareholders do not. In this case, greenmail is like any other form of compensation the firm pays to third parties for goods and services supplied.¹²⁵ That the supplier is also a shareholder is irrelevant, as long as the payment is commensurate with value received.

III. GREENMAIL AND THE GOVERNANCE OF THE PUBLICLY HELD CORPORATION

The foregoing has attempted a theoretical explanation of greenmail and a defense of its use in certain situations. Greenmail offers possible benefits to target firm shareholders without the deleterious effects (on target firms themselves as well as on the market) generally associated with other defensive tactics. Admittedly, discretion to pay greenmail also risks creating agency problems for shareholders. Our theory, while not denying the agency-cost problem, suggests that the problems are of a smaller magnitude with greenmail than with other defensive tactics. We have suggested that greenmail can provide benefits to shareholders that offset any agency problems. This does not mean that greenmail is an unmitigated good, but just that it is not an unmitigated bad, either. No unambiguous inference can be made from the mere fact that greenmail is paid: that phenomenon is consistent with both the shareholder-welfare and the agency-cost hypotheses. The decision to offer or accept greenmail depends upon factors which not only vary from firm to firm, but also vary over time for any given firm. These factors include the ability of the greenmailer successfully to manage the firm, the probability of a later, better tender offer being made, the extent to which the firm's shares are undervalued in the market, and the value of the information created by the greenmailer.

Thus, we conclude that courts and regulators should refrain from imposing legal rules that prohibit or penalize the payment of greenmail, at least until it is better understood. The remainder of this Section examines

125. To analogize, a manager who also owns shares of the firm receives dividends on his stock in precisely the same amount as any other shareholder, but also receives a salary as compensation for management services that other shareholders do not provide. Similarly, if greenmail payments compensate a particular shareholder for services that other shareholders do not provide, the payments hardly constitute unequal treatment.

Corporate Greenmail

the legal rules concerning greenmail and evaluates these rules in light of our analysis.

A. Legislative Initiatives Against Greenmail

The SEC has concluded that greenmail payments harm nonrecipient shareholders,¹²⁶ basing its conclusion on empirical evidence that the share price declines following such payments,¹²⁷ and on a fairness argument.¹²⁸ The "problem" of greenmail, the SEC believes, can be solved by federal legislation that would greatly restrict the ability of firms to pay greenmail.¹²⁹

126. *SEC Staff Says Greenmail Payments Depress Price of Target's Stock*, 16 SEC. REG. & L. REP. (BNA) 14 (Oct. 5, 1984).

127. *Id.* The SEC was apparently relying on the report from its Office of the Chief Economist, *supra* note 105.

128. In July of 1983, the SEC Advisory Committee on Tender Offers issued a report with 50 recommendations for changes in the federal regulation of tender offers and takeovers. See SEC Advisory Committee on Tender Offers, *Report of Recommendations*, FED. SEC. L. REPORTS (CCH) No. 1028 (July 15, 1983) (Special Report) (partially reproduced in [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶83,511, at 86,675). The SEC has proposed to regulate greenmail payments. See Lipton, *supra* note 7. Its proposal is based on the conclusions of its Advisory Committee. See Office of the Chief Economist, *supra* note 105, at 2.

The underlying premises and assumptions of the committee are the subject of some debate. Dean LeBaron, chairman of the SEC committee, claimed that the committee respected "free market forces in the operation of the U.S. securities markets" in formulating its recommendations. *Report of Recommendations*, *supra*, at iii (letter from LeBaron to Chairman Shad). But in a separate statement, committee members Frank Easterbrook and Gregg Jarrell called the Advisory Committee report "essentially a plea for more regulation." *Id.* at 70.

The committee was "particularly concerned with a target company's repurchase of its stock at a premium to market from a dissident shareholder." *Id.* at 46. The committee argued that corporate greenmail payments "generally serve little business purpose . . . but also [constitute] a practice whereby a control premium may be distributed selectively and not shared equally by all shareholders." *Id.* Greenmail payments cast doubt "on the integrity of the takeover process." *Id.* Thus the committee's Recommendation 43 stated: "Repurchase of a company's shares at a premium to market from a particular holder or group that had held such shares for less than two years should require shareholder approval. This rule would not apply to offers made to all holders of a class of securities." *Id.* (footnote omitted).

In addition, the SEC committee's Recommendation 37 (a)(iii), concerning standstill arrangements, stated that agreements restricting purchases or sales of the company's stock by a party to the agreement should be designated an "advisory vote matter" that would be disclosed in the firm's proxy material and reviewed at the annual stockholder meeting for the election of directors. *Id.* at 38. As Easterbrook and Jarrell point out, advisory votes are "costly and complicated," as well as meaningless. *Id.* at 104.

129. From the shareholder's perspective, state regulation is preferable to federal regulation. Competition among the states for corporate charters (and the tax revenues they imply) limits the ability of individual states to enact legal rules that reduce investor welfare. A firm can avoid inefficient state legal rules by moving its domicile to a state with a legal regime that maximizes the value of the firm's shares. See ECONOMIC REPORT OF THE PRESIDENT, *supra* note 9, at 215. For this reason, "state statutory and common law rules that survive over time, like private contractual arrangements, are presumptively welfare increasing." Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 882 (1983); see also R. WINTER, GOVERNMENT AND THE CORPORATION (1978); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U.L. REV. 913 (1982).

A conflicting view is that states compete with each other for corporate charters by adopting legal rules that favor the interests of managers over the interests of shareholders. The question of which

The SEC has asked Congress for legislation that would amend the Securities Exchange Act of 1934 to prohibit a target company from repurchasing its securities at a price above the current market price from any person who holds more than three percent of the outstanding shares, unless (1) a majority of shareholders approve the purchase, or (2) the offer is made to all shareholders.¹³⁰ The SEC's proposed legislation has garnered some support in Congress. In June 1984, just days after Walt Disney purchased Rupert Murdoch's 11.1% stake in the company at a premium over the current market price, Senator Donald Riegle introduced a bill based on the SEC's proposal.¹³¹ In Senator Riegle's words, "[u]nder current law there is nothing whatsoever illegal about these practices where it is possible to make millions upon millions of easy dollars."¹³²

1. *The Shareholder Approval Requirement*

As we observed earlier, one of the reasons shareholders may find it in their interests to give their agents the authority to make greenmail payments is that these payments inhibit two-tier tender offers that place the stockholders in a prisoner's dilemma. The dilemma prevents stockholders from realizing the full value of their shares in a corporate control transaction.¹³³ The SEC proposal, in calling for a shareholder vote, may return shareholders to precisely the same sort of dilemma. A shareholder vote against the payment of greenmail when a two-tier bid is expected, will most likely result in acceptance of the first tier of the two-tier bid.¹³⁴

There are other problems with the SEC's suggestion that shareholders vote on proposals to pay greenmail. Such votes increase the transaction costs associated with the decision to make targeted share repurchases. The

view is correct is an empirical one. A growing empirical literature supports the conclusion that competition causes state law to be responsive to shareholder demands rather than management demands. See R. Romano, *Some Pieces of the Incorporation Puzzle* (Dec. 1984) (Stanford Law & Economics Working Paper No. 19); Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985); Butler, *Nineteenth Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129 (1985); Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation*, 53 J. BUS. 259 (1980); see also ECONOMIC REPORT OF THE PRESIDENT, *supra* note 9, at 215 (available empirical evidence suggests that changes in corporate domicile correlate with increased stock price valuations).

130. See Lipton, *supra* note 7.

131. *Tender Offers*, 16 SEC. REG. & L. REP. (BNA) 1035 (1984).

132. *Id.* An alternative proposal to that of the SEC has been suggested by Senator John Chafee, who claims that his would go even further in impeding the ability of firms to pay greenmail. *Id.* The Chafee proposal would deny corporations that pay greenmail the ability to take a tax deduction for such payments. *Id.*

133. See *supra* text accompanying notes 32-41.

134. Bebchuk has proposed a solution to the prisoner's dilemma, which would require shareholders to make a conditional vote. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. (forthcoming 1985). Even if his proposal solves the prisoner's dilemma, it does not eliminate the potential utility of greenmail. See *supra* note 31.

decision about whether to pay greenmail requires large amounts of information. Free-rider problems make it highly unlikely that shareholders will find it in their interests to collect such information individually.¹³⁵ It makes sense to delegate this decision, like most others concerning governance of the firm, to management—but this is precisely what the SEC's proposed legislation would prevent shareholders from doing. Finally, the SEC's proposal lowers the probability of tender offer bids. Potential acquirers will be less likely to make initial, beachhead acquisitions because the probability of being compensated for the information provided by such acquisitions has now been significantly reduced.¹³⁶

2. *Requirement of Equal Payment to all Shareholders*

Like the unfairness doctrine in general, a legislative requirement that greenmail be prohibited unless the firm paying the greenmail makes the same offer to all shareholders ignores the fact that greenmailers may provide benefits to the paying corporation that other shareholders do not. As observed earlier, greenmailers invest significant resources in locating target firms and often increase the value of the firms in which they have made their initial investment¹³⁷ by supplying new information about such firms to the marketplace or to the firm.¹³⁸ As such, it is neither efficient nor equitable, *ex ante* or *ex post*, to require that all shareholders share in greenmail payments made by the firm.

Obviously, given a choice, many shareholders would like to sell their stock at prices above the current market price. While such a requirement might be seen as beneficial to shareholders *after* the greenmailer has made her acquisition, it is not in the best interests of the shareholders when viewed *ex ante*. The proposed equal payment requirement would harm non-recipient shareholders by reducing the amount of investment made by corporate-control entrepreneurs in target firms. This possible loss to non-recipient shareholders provides an explanation for why more shareholders have not amended firm charters to prohibit greenmail.

B. *Judicial Movement Against Greenmail*

In addition to the possibility that legislation will be enacted making greenmail payments illegal under federal securities law,¹³⁹ it is increas-

135. Cf. A. DOWNS, *ECONOMIC THEORY OF DEMOCRACY* 230–34 (1957) (voters may free-ride efficiently on third-party information). See generally M. OLSON, *THE LOGIC OF COLLECTIVE ACTION* 27–28 (1982) (discussing free-rider information problem).

136. See *supra* text accompanying notes 62–74.

137. See *supra* text accompanying note 115.

138. See *supra* text accompanying notes 121–25.

139. Even if the direct legislative initiatives described above fail to become law, greenmail pay-

ingly possible that courts may find that such payments violate the common law fiduciary duties (either of care or of loyalty) owed by managers to shareholders. Under current case law, the directors of a firm paying greenmail are required to state the business purpose of corporate actions taken to thwart a takeover bid. If courts view greenmail payments as simply vehicles for entrenching incumbent management, and if incumbent management cannot articulate coherent alternative justifications, such payments may be prohibited.

The first and leading Delaware case on the legal propriety of greenmail is *Cheff v. Mathes*.¹⁴⁰ In *Cheff*, shareholders of the Holland Furnace Company brought suit to hold certain corporate officers and directors liable for loss from improper use of corporate funds to pay greenmail. Holland paid greenmail to repurchase—at a premium over the prevailing market price—the Holland shares owned by one Maremont and certain corporations within his control. Maremont had acquired a large minority block of Holland stock, and then demanded a seat on the firm's board of directors. The plaintiff shareholders claimed that the "true motives" behind Holland's targeted share repurchase from Maremont "were improperly centered upon perpetuation of control."¹⁴¹ The inside directors responded that greenmail was paid to quell employee unrest and to ensure

ments still may be challenged under section 14(e) of the Securities Exchange Act of 1934, which was added by the Williams Act in 1968. 15 U.S.C. § 78n(e) (1981). The Williams Act was enacted to provide comprehensive regulation of tender offers. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1981)). See also H.R. Rep. No. 1711, 90th Cong., 2d Sess. 2-3, reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811, 2812-14 (observing that Williams Act was passed to curb abuses in cash tender offer markets). Section 14(e) prohibits "fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer."

Congress did not define "fraudulent," "deceptive," or "manipulative" anywhere in the securities statutes. Junewicz, *The Appropriate Limits of Section 14(e) of the Securities Exchange Act of 1934*, 62 TEX. L. REV. 1171, 1175 (1984). Although there have been no cases yet decided that have challenged the payment of greenmail under § 14(e), in the absence of any good theoretical justification for the payment of greenmail, the practice may be held to constitute a manipulative or deceptive practice in violation of § 14(e).

The Supreme Court recently held that, because § 14(e) is essentially a disclosure provision, there can be no violation of the statute absent proof of deception, misrepresentation, or nondisclosure. *Schreiber v. Burlington Northern, Inc.*, 105 S. Ct. 2458, 2462-63 (1985). Applied to greenmail, this interpretation of § 14(e) insulates from liability managers who pay greenmail so long as such payments are accompanied by full disclosure. When greenmail is paid in a clandestine way, however, the payments may be deemed a "deceptive practice." See Leefeldt, *'Greenmail,' Far From Disappearing, Is Doing Quite Well in Disguised Forms*, Wall St. J., Dec. 4, 1984, at 10, col. 1 (discussing recent trend of greenmailers to use disguised tactics).

The biggest obstacle to plaintiffs' challenges to corporate greenmail payments under § 14(e) is the requirement that the misleading practices be in connection with a tender offer. Corporations may pay greenmail, or do a variety of other things, such as engage special legal counsel or amend the firm's by-laws, in anticipation of a tender offer, but these actions seemingly would not be considered to be in connection with a tender offer, in the absence of some additional, unusual facts. For this reason alone, even surreptitious greenmail payments are not likely to be found to violate § 14(e).

140. 41 Del. Ch. 494, 199 A.2d 548 (1964).

141. *Id.* at 504, 199 A.2d at 554.

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that the firm's unique retail sales techniques were retained.¹⁴² The court held that the business judgment rule insulated the officers from liability for such corporate acts as paying greenmail unless the officers "acted solely or primarily because of the desire to perpetuate themselves in office."¹⁴³ The defendants satisfied their burden of proof by showing "reasonable grounds to believe a danger to corporate policy and effectiveness existed by the presence of the Maremont stock ownership."¹⁴⁴

The standard espoused in *Cheff* was reaffirmed in the 1977 case of *Kaplan v. Goldsamt*.¹⁴⁵ In *Kaplan*, the plaintiff, a stockholder in the firm paying greenmail, alleged that greenmail was paid to avoid a hostile proxy fight that might have led to a shift in control.¹⁴⁶ The court wrote that greenmail was proper if its purpose was "to eliminate what appears to be a clear threat to the future business or the existing, successful business policy of a company."¹⁴⁷ The court concluded that because management's sole purpose of making the targeted stock repurchase was not to perpetuate itself in control, the management decision to pay greenmail would be protected by the business judgment rule.¹⁴⁸

In the past, this legal standard has enabled defendants to avoid a showing that they have breached their fiduciary duty to the shareholders sim-

142. *Id.* at 502-07, 199 A.2d at 553-55. One of Holland's "unique retail sales techniques" was, without permission, dismantling the furnaces in prospective customers' homes and then claiming that the furnaces could not be reassembled without danger, in order to sell a new Holland furnace. In addition, Holland salesmen made claims that furnaces sold by their competitors were dangerously defective and that continued use could result in serious injury. *In re Holland Furnace Co.*, 55 F.T.C. 55, 64-80 (1958). The company consistently lost money under management of the group that bought Maremont out. Ultimately, however, the incumbent management team was replaced, and the firm changed its name to Athlone Industries. For further details on the denouement of the Holland Furnace story, see W. CARY & W. EISENBERG, *supra* note 36, at 677-78. Of course, there is no way to ascertain whether the company's shareholders fared better under Athlone's management than they would have under Maremont. The fact that the firm ultimately was taken over despite its greenmail payment supports the argument made in this Article that the payment of greenmail is an ineffective defensive technique.

143. 41 Del. Ch. at 504, 199 A.2d at 554.

144. *Id.* at 506, 199 A.2d at 555.

145. 380 A.2d 556 (Del. Ch. 1977). The standard espoused in *Cheff* was also endorsed, albeit in dicta, in *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985). Mesa Petroleum acquired a large minority block of stock in Unocal. Unocal responded by offering to purchase, at a premium, all outstanding shares except those owned by Mesa. The Supreme Court of Delaware upheld Unocal's right to make such selective stock repurchases, and endorsed its earlier holdings in *Cheff* and *Kaplan*. *Id.* at 957.

146. 380 A.2d at 558-61.

147. *Id.* at 569. Medicorp purchased Goldsamt's stock for \$9.50 per share even though the company was buying shares in the open market for \$6½ to \$7.00 per share. *Id.* at 562. It was uncontroverted, however, that the Medicorp board of directors knew the stock to be undervalued. *Id.* at 559. Thus the purchase of Goldsamt's shares may have been a good investment for the company, particularly if the firm could not have acquired such a large block of stock in the open market as cheaply.

148. *Id.* at 569. The court in *Kaplan* stressed the desirability of appraisal of a firm's stock by an outside expert "selected with reasonable care" before the payment of greenmail. *Id.* at 568 (construing Delaware statute). Such an appraisal seems to be one of the more reliable ways in which a target board voting to make a greenmail payment can protect itself against liability for waste of corporate funds. *Id.* at 566-69.

ply by showing that they have some policy difference with the raider.¹⁴⁹ Thus, the business judgment rule has frequently resulted in courts' condoning greenmail without carefully examining the merits of the practice from the perspective of the stockholders.¹⁵⁰ In these cases, the share repurchase was invalidated only when no rationale was offered.¹⁵¹

These applications of the business judgment rule to greenmail mirror the rule's traditional application to managerial actions affecting corporate control generally.¹⁵² An example is the 1980 case of *Johnson v. Trueblood*,¹⁵³ where the plaintiff-shareholders claimed that, in order to preserve their control of a corporation, the defendants sold newly issued stock to themselves rather than sell at a higher price to plaintiffs. The court specifically rejected the contention that the plaintiff can satisfy his or her burden merely by showing that a desire to retain control was a motive.¹⁵⁴ The court, construing Delaware law and relying principally on *Cheff v. Mathes*, held that the plaintiff must show that "impermissible motives predominated in the making of the decision in question."¹⁵⁵

But recent cases outside Delaware construing the propriety of management conduct affecting corporate control suggest that courts are limiting the business judgment rule for defensive tactics generally, and are placing an increasingly heavy burden of explanation on management. A recent Second Circuit opinion, *Norlin Corp. v. Rooney, Pace Inc.*,¹⁵⁶ exemplifies this trend towards limiting the business judgment rule.

Norlin management, in an effort to forestall a takeover, sold substantial

149. Israels, *Corporate Purchase of Its Own Shares—Are There New Overtones?*, 50 CORNELL L.Q. 620, 624 (1965).

150. See Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977); Heine v. The Signal Cos., [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,898, at 91,311 (S.D.N.Y. 1977). See also Tobin & Maiworm, *Beachhead Acquisitions: Creating Waves in the Marketplace and Uncertainty in the Regulatory Framework*, 38 BUS. LAW. 419 (1983); Nathan & Ziegler, *Issuer Stock Repurchases*, 14 REV. SEC. REG. 925 (1981); Nathan & Sobel, *Corporate Stock Repurchases in the Context of Unsolicited Takeover Bids*, 35 BUS. LAW. 1545 (1980).

151. Crane v. Harsco Corp., 511 F. Supp. 294, 305 (D. Del. 1981) (greenmail invalidated when directors failed to offer rationale for its payment).

152. Easterbrook & Jarrell explain the rationale for the business judgment rule:

The business judgment rule gives managers the freedom to err, and thus it facilitates risk-taking. Perhaps more fundamentally, it reflects the fact that error-prone managers eventually are "selected out" by the process of competition among firms and among managers themselves. Judges, on the other hand, are not chosen for their business acumen and are not fired or subject to reductions in salary if they err in assessing business situations Tender offers create conflicts of loyalty in almost every case: to defend against the offer is to defend against a threat to one's job as well When the evidence of conflict is convincing—when certain kinds of self-interested decisions always or almost always turn out poorly for the shareholders—the rationale of the business judgment rule is seriously undermined.

Easterbrook & Jarrell, *supra* note 3, at 277-78 (footnote omitted).

153. 629 F.2d 287 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981).

154. *Id.* at 292-93.

155. *Id.* at 292.

156. 744 F.2d 255 (2d Cir. 1984).

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amounts of its stock to a Panamanian subsidiary and to a newly created stock ownership plan. Management controlled the voting of both blocks of stock, and, as such, the issuance of the stock resulted in a change in control of the corporation.

According to the *Norlin* court's formulation of the business judgment rule, if retention of control was simply *a factor* in the management's decision to engage in a particular defensive tactic, "the burden shifts to the directors to 'prove that the transaction was fair and reasonable to the corporation.'"¹⁵⁷ The court expressly rejected the position that once management "concludes that an actual or anticipated takeover attempt is not in the best interests of the company, a board of directors may take any action necessary to forestall acquisitive moves."¹⁵⁸ The court introduced a requirement that a board show that any actions it takes are "fair and reasonable."¹⁵⁹ If this standard were applied to greenmail, payments would be invalidated when a defendant is unable to formulate a theoretically convincing rationale for the greenmail.

Thus, while all of the cases interpreting the business judgment rule still hold that the initial burden is on the plaintiff to show a conflict of interest, courts disagree as to precisely what sort of conflict of interest must be shown. And courts seem more willing to shift the burden of explanation to the defendant than previously. All agree that if the plaintiff can show that a desire to perpetuate control was the defendant's *sole* reason for paying greenmail, the burden shifts to the defendant to show that the transaction was fair and reasonable to the corporation. *Norlin*, however, goes beyond this formulation, and holds that even if a desire to perpetuate control is only a factor in management's decisionmaking process, the burden shifts to the defendant. That rule could result in an abolition of the protections of the business judgment rule in all corporate control transactions, including greenmail. This, of course, would be a significant shift from earlier cases such as *Cheff v. Mathes* and *Johnson v. Trueblood*, which hold that directors enjoy the benefits of the business judgment rule so long as their activities arguably benefit the corporation.

A principal implication of the analysis presented in this Article is that courts should not invalidate greenmail payments solely because such payments are made to entrench incumbent management.¹⁶⁰ Regardless of the motivation for paying greenmail, payments should be permitted so long as shareholders are better off. The reason shareholders do not generally prohibit greenmail may be that the payments benefit nonrecipient sharehold-

157. *Id.* at 265 (quoting *Treadway Cos. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980)).

158. *Id.* at 265-66.

159. *Id.* at 266.

160. *See supra* notes 98-100 and accompanying text.

ers when viewed *ex ante*, and often do so *ex post* as well.¹⁶¹ Thus, the test of greenmail ought not be whether management acts altruistically. The ideal test would be whether or not the actions of management benefit the shareholders.

But, even if the net result of a greenmail payment is a decrease in a firm's share price, it does not necessarily follow that the payments had a negative net expected value *ex ante*. The fact that a particular business decision turns out badly does not suggest that shareholders would want to ban managers from making such decisions. The question, then, becomes whether the legal system can supplement the contracting process by which firm wealth is maximized. One contractual control against wealth-reducing greenmail payments is amendments to corporate charters.¹⁶² Not only may some firms wish to ban greenmail and other firms wish to allow it,¹⁶³ but a particular firm may decide it best to restrict greenmail in certain circumstances and to permit it in others.¹⁶⁴ The legal system, which

161. See *supra* text accompanying notes 108–18.

162. See *supra* text accompanying notes 92–94.

163. Any attempt to ban or regulate greenmail will diminish shareholder wealth unless it permits shareholders to “contract around” or “opt out” of their provisions. Coase has shown that, absent transactions costs, property rights inevitably will be allocated to their highest valued user. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). Applied to greenmail, this suggests that it may not matter whether the law allows managers to pay greenmail or not, so long as shareholders and managers can freely contract out of the initial rule. If contracting out is permissible, questions such as whether a manager will be allowed to make greenmail payments will be negotiated as part of the cost of hiring the manager. If the costs of allowing managers to pay greenmail are thought to outweigh the benefits, the payments will be proscribed.

Corporate law is efficient only as long as it serves as a standard form contract that shareholders and managers freely can alter. R. POSNER, *ECONOMIC ANALYSIS OF LAW* 296 (2d ed. 1977). The standard form contract is efficient when it lowers transactions costs (including contracting costs) and thereby lowers the costs of doing business. *Id.* If transactions costs are already low, however, firms can be expected to insert any restrictions on greenmail they consider valuable directly into the articles of incorporation and into the managers' employment contracts. The cost to firms of adding such provisions often is negligible, particularly when new firms draft their charters. See *supra* text accompanying notes 93–94.

164. For example, firms may decide to permit managers to pay greenmail only when there is some indication that a subsequent bid is on the horizon. If such a rule were in place, managers could defend a shareholder's legal challenge of a decision to pay greenmail by adducing evidence showing that they had reason to believe such an offer was forthcoming at the time the payment was made. Alternatively, shareholders might permit managers to defend greenmail payments by having experts, such as investment bankers, submit evidence that a particular bid was inadequate, and that higher bids could be expected in the near future.

Shareholders who are particularly suspicious of incumbent management's motives might choose to ban greenmail outright. Alternatively, such shareholders might choose to impose a rule permitting managers to pay greenmail, but requiring incumbent management to offer to purchase the firm's shares itself in a leveraged buy-out (presumably at a price equal to or higher than the greenmailer's offer) if a second offer did not materialize within a certain period of time. This would require management paying greenmail for the ostensible reason that a subsequent, higher offer might be forthcoming to “put its money where its mouth is.” The problem with such a provision would be that risk-averse managers may decline to pay greenmail even where such payments have a positive net expected value because of the fear that they will be required to purchase the firm if they are mistaken as to the value of the firm's shares or the probability of a subsequent offer being made.

The alternatives listed here are only examples of how individual firms can write charter amend-

develops standard form rules applicable to all firms and usually to all situations, cannot provide this kind of customization. While standard form contracts serve a valuable purpose in lowering transaction costs,¹⁶⁵ for shareholder wealth to be maximized, firms must be allowed to alter these rules to meet the particular needs of their investors.

Consistent with this view of the corporation as standard form contract, courts passing on the propriety of greenmail payments should recognize not only the agency-cost problems inherent in such transactions; they also should acknowledge that, as this Article has shown, rational, value-maximizing shareholders often will delegate to managers the authority to make greenmail payments. This authority can increase shareholder wealth by raising the probability that takeover bids will take place, and also by improving the quality of the auction market for a firm's shares should such a bid be made.

Further, courts must recognize that, after the fact, it is difficult to determine whether a specific greenmail payment ultimately served the interests of the shareholders. It is even more difficult to tell *ex post* whether the payments had a positive expected value when viewed *ex ante*. Yet this is the task the legal system has assigned to itself.¹⁶⁶

Thus the only possible justification for using managerial motive as a test of the legal propriety of greenmail payments is that motive may be an implicit proxy for determining whether greenmail was in the best interests of the shareholders *ex ante*.¹⁶⁷ As discussed above, managerial motive may in fact be a poor proxy.¹⁶⁸ The holding in the *Norlin* case, as well as

ments to suit their particular needs in a way that the legal system cannot. Particular firms will choose to adopt these or other rules on the basis of the costs and benefits that such rules pose for the firm.

165. See R. POSNER, *supra* note 163, at 296.

166. In a world devoid of information costs, courts could easily accomplish this task. Of course, in such a world, articles like this one would not have to be written. There would be no prisoner's dilemma facing target shareholders. There would be no need to create auction markets for a firm's stock because all shares would be accurately valued at all times. Cf. G. GILMORE, *THE AGES OF AMERICAN LAW* 111 (1977) ("In heaven there will be no law, and the lion will lie down with the lamb.").

167. Motivation is only relevant to the issue of judicial economy. It may be less costly for the judicial system to evaluate the motives of a particular managerial team than to ascertain the expected value of a particular greenmail payment. Judges are trained to evaluate evidence bearing on questions of motive and intent, and are called upon to make such evaluations in virtually all areas of law. For a discussion of courts' special areas of institutional competence, see Judge Winter's analysis of derivative suits in *Joy v. North*, 692 F.2d 880, 888-89 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

168. Motives are almost impossible to distinguish and sort. "There is no signal that separates intransigent resistance from honest efforts to conduct an auction for the shareholders' benefit." *Management Role*, *supra* note 14, at 1175. In the case of greenmail especially, the observation that substantial minority blocks are repurchased is not inconsistent with either the efficiency or the agency-cost hypothesis, and thus provides no information about managerial motives. But particularly in the market for corporate control, they are largely irrelevant. As the court recognized in *Johnson v. Trueblood*, managers *always* act selfishly: "[B]y the very nature of corporate life a director has a certain amount of self-interest in everything he does. The very fact that the director wants to enhance corporate profits is in part attributable to his desire to keep shareholders satisfied so that they will not

Cheff v. Mathes and its progeny, all shift the burden to the defendant to justify defensive tactics whenever a desire to retain control plays a role in management's actions. This approach is inconsistent with the reasoning in this Article.

While the value of a motivation test is dubious, a judge certainly can increase shareholders' welfare by enforcing the contracts that they agree to themselves. Thus, when evaluating greenmail payments, courts should focus first on whether the managers who paid greenmail violated any express or implied agreement not to make such payments.¹⁶⁹ Only in the absence of any express or implied agreement should a management decision to pay greenmail be questioned, even under the business judgment rule.¹⁷⁰ If management is permitted by contract to pay greenmail, such payments do not violate any fiduciary duty, and thus inquiry into managerial motive is irrelevant.¹⁷¹ In the absence of contractual permission, evidence adduced by financial economists or other experts showing that the greenmail payment in question had a positive net expected value when made should trump less relevant evidence about managerial motivation.

IV. CONCLUSION

This Article has tried to show why shareholders might want managers to pay greenmail. We have not proven that greenmail is always "good," simply that it need not be "bad." 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 motiva-

oust him." 629 F.2d, at 292.

169. For more complete discussions on the topic of optimal legal sanctions in the corporate setting, see Fischel & Bradley, *supra* note 77; Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984); Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982).

170. See *supra* note 164 (giving examples of hypothetical charter provisions permitting greenmail to be paid under certain circumstances). Coase's theorem implies that, absent transactions costs, we would be indifferent between a default rule permitting greenmail to be paid and a default rule banning the practice. See Coase, *supra* note 163.

171. Unfortunately, as a practical matter it is not at all clear what legal effect a specific charter provision permitting greenmail to be paid would have. While there have been charter provisions banning greenmail, we know of no provisions expressly permitting these payments. A likely reason for this is that managers and shareholders do not believe that such provisions will carry much weight in court. Another possible explanation is that lawyers' lack of understanding of the economic justifications for greenmail has led them to believe that charter provisions permitting greenmail payment might themselves be the subject of court challenge by dissident shareholders. A third possibility is that the current interpretation of the business judgment rule has led shareholders and managers to believe that such provisions are unnecessary.

This leads us to point to an additional advantage to shareholders of the approach suggested in this Article. When a shareholder challenges a greenmail payment that had a positive expected value, the corporation's defense of the lawsuit consumes real resources, whether or not the shareholder ultimately wins or loses. By making it clear that plaintiffs who challenge greenmail payments will inevitably lose when the payments have been made under authorization in the corporate charter, there will be fewer lawsuits, and a concomitant reduction in this waste of real resources.

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tion, 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 (and indeed the central question in drafting rules of corporate governance generally) 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. There is good evidence in favor of this proposition, but the evidence is not unequivocal. This, in itself, counsels against hasty revision of the law.