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Share Buybacks

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INTRODUCTION

Share buy-backs, the top candidates. That was the title of the front page of Finance Week, April 2, 1999. One cannot tell on first sight whether this is meant to be good or bad news, or relevant news at all. But the title indicates an increasing interest among financial analysts, whether firms will be able to buyback their own shares or not. After reading the article one can be certain. Share buybacks are supposed to be exactly what the capital markets always wanted to have, but what was always denied to them. The article demonstrates one vital reason why share buybacks are advantageous for companies: The signalling effect for the market. Although buybacks in certain situations are hardly helpful for the companies, they are generally treated as a panacea. That creates a loophole. Once a company announces its intention to repurchase its own shares, the share market price increases. Because of that knowledge management is enticed into manipulating the market price. The situation is fairly exaggerated, but elucidates a common problem on stock markets. The market price is not only a reflection of the company's performance, but is also influenced by psychological factors which appear to be almost irrational. Bearing that in mind, a discussion of a legal framework for the repurchase of shares is somewhat difficult, and weighing the advantages and disadvantages is, to a large extent, a matter of personal taste.

South Africa was in good company in prohibiting repurchases of shares in general. Almost every state all over the world restricted share buybacks to the extent that they hardly ever took place. Off course there was one major exception: the United States of America. After following the early English case of *Trevor v Whitworth*[1] in prohibiting share buybacks, state legislation and early decisions in the United States abolished the prohibition. Instead they chose directly the opposite. Only a few restrictions were imposed, and management was, and is, vastly free in buying and selling the shares of their company. The world noticed what happened in the United States, but especially lawyers and politicians of other countries always emphasised the risks of share repurchases. They stuck to their prohibitions, and did not think about reformations until very recently. Nowadays it seems that changing the regulations about share buybacks is en vogue. One could describe it as a race. Countries which have not changed their legislation yet are very concerned not to fall behind the standards set by other countries. 'Global market' is no longer just some jargon used in newspapers; it has become reality. Since the economics of countries all over the world are dependent upon major companies, which cater for employment and taxes, nobody wants to loose these

companies as a result of domestic legislation restricting financial management. The constant pressure from managers and economists surely played a major role in starting the 'revolution'. Most of the European Union states have already changed their legislation as well as Australia and New Zealand. South Africa is on the verge of doing so. The Bill has already been passed parliament and is signed by the president. The new provisions will come into force on June 1, 1999. That is reason and incentive to have a closer look at share buybacks, especially at the various legislation surrounding it. A comparative analysis is supported by the Constitution of South Africa. When interpreting the bill of rights a court, tribunal or forum may consider foreign law (section 39 (1)(c)). Generally the standpoint in South Africa is, one should always consider the legal developments in foreign countries. It facilitates the discussion about any change in laws. As a native German, the author wishes that a similar approach would be considered in Germany.

Share buybacks are so overwhelmingly positively described that one instantly wonders why they were prohibited for such a long time. Japan gives a good example of this. In the 1990's, Japan abolished the general prohibition for a company to buyback its own shares. As a safeguard against managerial abuses, approval from the general shareholders' meeting was necessary. Just a short time afterwards, the requirement of shareholders approval seemed not to be up to date, and Japan changed its legislation again.[2] The revised Commercial Code provides, since June 1, 1997, that a company requires only the approval of its board to buyback its shares.

Given the fact that so many states have already abolished a prohibition of this kind, and that South Africa will certainly follow, arguing against permitting share buybacks is no longer of practical use. The more pertinent question would be now how most effectively to regulate share buybacks. A balance between the company's financial interests, and the protection of adversely affected individuals, has to be found. South Africa, as one of the last countries to change its regulations, has the great advantage of learning from other regulations.

The thesis will commence with the methods of acquiring stock (I.), followed by the advantages (II.) and disadvantages (III.) of repurchases. In a comparative section (IV.) the legislation and case law of Europe, the USA and New Zealand will be examined. Europe was chosen because of the author's legal background as a lawyer, educated

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[1] (1887) 12 App.Cas. 409.

[2] JAPAN WEEKLY MONITOR, May 26, 1997 (Lexis, legal news, catchword: repurchase of shares and buybacks).

in Europe. The USA offers the most liberal approach to share repurchases and especially the Delaware case law provides an ever interesting field for research. One must also not forget that the American attitude to repurchases gave the reason for relaxing regulations in other countries. Finally, New Zealand's regulation is of interest, because it contains a comprehensive approach to the problem and obviously functioned as a model for the new South African regulation. In part V., South Africa's situation is described. The Bill and the explanatory notes (memorandum) are scrutinised and compared to the other countries' regulations.

I. METHODS OF ACQUIRING STOCK

A repurchase of a company's own shares takes place when there is an agreement between the selling shareholder and the buying company to sell a certain number of shares. Nevertheless, the terms and conditions of possible transactions are diverse. Because of few restrictions on repurchases of own shares in the USA, most forms of repurchases came into existence and have developed there. Therefore, the discussion is based on the current situation in the USA, and refers to the terms used there.

In general one can distinguish between self-tender offers[3], open market repurchases[4] and greenmail.[5] Of the three methods, tender offers generally involve the largest repurchase of stock.[6] This is because anonymous open market repurchases can lead to an unacceptably high level of stock prices, and the shares would therefore be unaffordable to repurchase by the issuing company.

One can say that differences between the three methods are determined by the transparency of the transaction for the capital markets, the participation of the shareholders involved in the transaction, and the necessity to pay a premium.[7]

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[3] *See* COPELAND & WESTON, *Financial Theory and Corporate Policy* 597 (3rd ed. 1988); Masulis, *Stock Repurchase by Tender Offer: An Analysis of the Causes of Common Stock Price Change*, 35 The JOURNAL OF FINANCE 305 (1980).

[4] *See* COPELAND & WESTON, *supra* note 3, at 596.

[5] Also often referred to as privately negotiated purchases. Compare Dann & DeAngelo, *Standstill Agreements, Privately Negotiated Stock Repurchases and the Market for Corporate Control*, 11 JOURNAL OF FINANCIAL ECONOMICS 275 (1983); Masulis, *supra* note 3, at 305. Others call it negotiated premium buybacks: COPELAND & WESTON, *supra* note 3, at 738.

[6] Masulis, *supra* note 3, at 305.

[7] Jensen & Smith, *Stockholder, Manager and Creditor Interest: Application of Agency Theory*; in: ALTMANN & SUBRAHMANYAM, *Recent Advances in Corporate Finance* 93, at 115 (1985).

A. Open Market Repurchase

Throughout the world open market repurchases are the most frequently used method of stock repurchases. A company will usually announce the repurchase of a relatively small number of shares within a given time period. The transaction takes place on the secondary market (if it is a publicly traded company registered on the stock exchange) via a broker. No premium will be offered and the transaction is anonymous. The selling shareholder does not know whether he sells to the company or a third party. There is no discrimination of shareholders because every shareholder is free to sell his shares at the current market price or keep his stock. Open market repurchases provide shareholders with cash, but they do not have the effect of signalling that the stock is undervalued, as would be the case with self-tender offers.[8]

B. Self-tender Offers

A self-tender offer is an offer to all or part of the shareholders[9] to tender their shares to the issuing company at a price specified by the bidder. Usually a premium will be offered and the company announces the conditions of the offer. Self-tender offers have to be distinguished from open market purchases. In *SEC v. Carter Hawley Hale Stores, Inc.*[10], the court of the Ninth Circuit held that a company's open market purchases of over 50 percent of its stock, made to defeat a third party's tender offer, was not a tender offer, and therefore not subject to regulations under the SEC's Rule 13 (e)(4), which regulates issuer tender offers. This indicates a rather formalistic distinction of open market purchases and self-tender offers.

Different forms of self-tender offers have evolved:

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[8] Comment & Jarrell, *The Relative Signalling Power of Dutch-Auction and Fixed-Price Self-Tender Offers and Open-Market Repurchases*, 46 THE JOURNAL OF FINANCE 1243, at 1248 (1991).

[9] E.g. exclusionary self-tender offers, (also referred to as reverse greenmail) where the company forbids another bidder, who is attempting a hostile takeover, from tendering his shares into the offer. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[10] 760 F.2d 945 (9th Cir. 1985).

1. Fixed Price Tender Offer

The fixed price tender offer is the traditional form of self-tender offers, and is common if a large number of shares is to be repurchased. The company specifies a single purchase price in advance for which it will buy shares. At the same time, the number of shares sought, and an expiration date for the offer, will be stipulated. The offered price is generally above the market price (premium).

If more shares are tendered than the bidder has offered to accept, the shares will be bought on a 'pro rata' basis.[11] Therefore a tendering shareholder will not be able to sell all his tendered shares provided the aforementioned situation is going to happen. Fixed price self-tender offers run the risk of a loss of efficiency when the premium is either too high or too low. If it is too low, there will be an insufficient number of tendering shareholders, and not all shares sought after will be repurchased. If the premium is too high, the positive yield influences – which are one goal of the repurchase program – are weakened.

2. Dutch Auction Offer

The fundamental difference between the fixed price tender offer and the Dutch Auction repurchase is that the tender offer is made for one price, whereas the Dutch Auction offer specifies a range of prices from which shares will ultimately be purchased.[12] A tendering shareholder informs the offering firm of the number of shares he is willing to sell and his minimum acceptable selling price.[13] The firm compiles all of these responses and pays the lowest price that allows it to buy the number of shares sought in the offer.[14] Under the best price provision required by the SEC in the USA, the purchase price is paid to all investors who tendered at or below that price.[15] In a typical Dutch Auction, the minimum price is a few percent above the market price, while the maximum price represents a premium similar to the average for fixed price offers.[16] If the number of shares tendered exceeds the number sought, the company

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[11] For the United States *see* section 14 (d) (6) of the SEC Rules. Not every country requires the issuer to pro rate its offer.

[12] Bagwell, *Share Repurchase and Takeover Deterrence*, 22 RAND JOURNAL OF ECONOMICS 72, at 74 (1991). In the USA Dutch Auctions are permitted under Rule 13 (e) (4) governing tender offers, if conducted pursuant to certain procedures.

[13] Comment & Jarrell, *supra* note 8, at 1247.

[14] Bagwell, *supra* note 12, at 74; Comment & Jarrell, *supra* note 8, at 1247. This price is called closing– or market clearing price.

[15] Section 14 (d)(10) of the SEC Rules.

[16] Comment & Jarrell, *supra* note 8, at 1247.

purchases on a pro rata basis, like in a fixed price self-tender offer. In a Dutch Auction there is hardly the problem of finding the right premium, so the risk of an incorrect premium is almost not existing. On the other hand, the signal given to the market by the repurchase program is not as strong as with a fixed price tender offer.[17] In addition to that, in the event of oversubscription, the purchase price in a Dutch Auction is generally lower than the purchase price in a fixed price tender offer.

The first firm ever to announce a Dutch Auction was Todd Shipyards in 1981 originally planing a self-tender offer at $ 28. After they chose the Dutch Auction the ultimately purchase price was $ 26,50.[18] Dutch Auctions are also frequently used to accelerate repurchases when originally just open market purchases were planed.[19]

3. Transferable Put Rights

A modern form of stock repurchases is repurchasing shares by issuing transferable put rights to shareholders. The company issues put options to each shareholder in proportion to the number of shares owned. For instance, if there is a planned repurchase of 10 percent of the company's outstanding shares, each shareholder would receive one transferable put right per ten shares of stock owned.[20] The transferable put right provides the shareholder with the right to sell shares of stock back at a fixed price, within a specified period. Shareholders do not have to sell shares back. Instead, they can sell their transferable put rights on the open market. This method eliminates the proration and undersubscription risk of a fixed self-tender offer, but bears other risks like fixing the basic price for the put rights.

C. Greenmail

Greenmail is when the company buys its shares from one or a small number of shareholders at a premium above the market price.[21] The repurchase is usually executed in order to eliminate a potential hostile takeover bid by a shareholder, who

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[17] *Compare* Comment & Jarrell, *supra* note 8, at 1247.

[18] WALL STREET JOURNAL, September 23, 1981; cited after Bagwell, *supra* note 12, at 73.

[19] *See* Frank v. Arnelle, Lexis 176 (Del. Ch. 1998) with a comprehensive description about the history of a Dutch Auction initiated by WMX Technologies, Inc.

[20] Kale, Noe & Gay, *Share Repurchase through Transferable Put Rights*, 25 JOURNAL OF FINANCIAL ECONOMICS 141 (1989).

[21] *See* Polk v. Good, 507 A.2d 531, at 537 n. 3 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, at 956 n. 13 (Del. 1985).

already holds a substantial portion of the target company's shares. The accumulation of such a threateningly large block of the target's stock is usually achieved at a relatively low price. In most cases, the potential bidder would let the target know that he has acquired a substantial block of shares. The acquirer then indicates that it would be amenable to sell the block to the issuer at a premium above the market price.[22] This is the most far-reaching possibility for management to deal in the company's own stock. This always involves discrimination against the other shareholders, since the offered premium is not available to them. In most countries where share repurchases are allowed, however, greenmailing is prohibited in general. In the USA greenmailing is the most controversial discussed phenomenon of share repurchases and therefore one can find numerous decisions concerning this problem.

II. Reasons for the Repurchase of own Shares

There are reasons which are generally recognised. These concern the redemption of preferred shares, to compromise a shareholders debt to the corporation and to eliminate fractional shares. Many countries allowed repurchases on ground of those reasons despite prohibiting share buybacks in general.

A. Advantages Concerning the Financial Structure of the Company

There are two principle types of repurchases. The first is where the firm has cash available for distribution to its shareholders, and the second is where the firm concludes that its capital structure is too heavily weighted with equity. In the latter case, the firm sells debt and uses the proceeds to buy back its shares.[23] So the repurchase of a company's own shares can be used to increase the value of the company. It is an instrument with which the management has the possibility to act in the light of the shareholder value principle.[24] Throughout the world creating shareholder value is becoming a more and more important goal which has to be achieved by management, and against which management actions will be measured.

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[22] Nathan & Sobel, *Corporate Stock Repurchases in the Context of Unsolicited Takeover Bids*, BUSINESS LAWYER 1545, at 1564 (July 1980).

[23] BRIGHAM & HOUSTON, *Fundamentals of Financial Management* 568 et seq. (8th ed. 1998).

[24] *Compare* RAPPAPORT, *Creating Shareholder Value. The New Standard for Business Performance* (1986).

1. Stock Repurchases as an Alternative to Cash Dividends

The cash dividend is still the predominant method for companies to pay its shareholders. However, in the USA, stock repurchases have become increasingly popular.[25] Both actions involve a cash flow from the firm to its common stockholders.[26] While the cash distribution in paying a dividend is obvious, since every shareholder receives actual cash per share, this effect is less clear in the case of stock repurchases. The shareholders have a choice when the firm distributes cash by repurchasing stock – they can either sell or not sell their shares.[27] Those shareholders who need cash, or want to invest elsewhere, can sell back some or all of their shares; in the case of a self-tender offer with a premium above the market price, and in the case of an open market purchase for an increased market price, resulting from the announcement of the company to buy back its shares. Those who do not need cash, or do not want to invest in other projects, can retain their stock and should profit as well from doing so. This is because of the increased earnings per share ratio resulting in a higher market price per share.[28] If stock is repurchased by the company, fewer shares will remain outstanding. Assuming that the repurchase program does not adversely affect future earnings, the consequence is that the same profits as before facing fewer shares. Therefore share repurchases have exactly the same effect as dividend payments, except that the form of payment is capital gains instead of dividend income.[29]

There are certain distinctive differences between paying dividends and stock repurchases which count in favour of the latter. These differences are closely connected to the so-called signalling effects.[30] Repurchase announcements regularly lead to an increased market price, because investors believe that the motivation for the repurchase is management's decision that the firm's shares are undervalued. On the other hand, there is also a signalling effect in the form of an increased dividend. In theory, however, the market expectations are different. An increased dividend results in the expectation that there will be the same dividend paid next year. A cut in dividend

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[25] *See* Bagwell & Shoven, *Cash Distribution to Shareholders*, 3 JOURNAL OF ECONOMIC PERSPECTIVES 129, at 131 (1989). They provide a table of annual cash distribution to shareholders from 1977 to 1987.
[26] Masulis, *supra* note 3, at 305.
[27] BRIGHAM & HOUSTON, *supra* note 23, at 570.
[28] BRIGHAM & HOUSTON, *supra* note 23, at 569.
[29] COPELAND & WESTON, *supra* note 3, at 498.
[30] *Compare* Comment & Jarrell, *supra* note 8, at 1243; Dann, *Common Stock Repurchases: An Analysis of Returns to Bondholders and Stockholders*, 9 JOURNAL OF FINANCIAL ECONOMICS 113 (1981); Vermaelen, *Common Stock Repurchases and Market Signalling*, 9 JOURNAL OF FINANCIAL ECONOMICS 139 (1981).

payment would therefore give a negative signal to the market.[31] The market price would decrease. That means if the increase in dividend payments cannot be maintained in the future, a stock distribution program should rather be selected instead of a dividend payment to shareholders.

By splitting the distribution into a dividend component (with a relatively low payout ratio so that this level may be maintained in the future) and a repurchase component, the company gains more flexibility.[32] According to BRIGHAM & HOUSTON[33], this procedure is the primary reason for "the dramatic increase in the volume of share repurchases" in the USA.

Another advantage of repurchase programs is that they can be carried out throughout the year, and do not have to be executed on a fixed date, as with the annual general meeting. There is also the problem that dividends are highly taxed and, in most countries, tax considerations alone are a crucial reason for prefering repurchase programs to paying dividends.

2. Repurchases as Financing Instruments

A company may trade in its own stock if this is permitted under the particular legal system. Corporate management probably has the best perspective from which to value and judge the situation of its firm. A declining or undervalued stock may lead to the assessment by management that the company's own stock is the best available 'investment' on the market.[34] After the repurchase program, management waits until the market price increases, and then sells its stock in the open market. Naturally this requires that repurchased shares are held as treasury stock, or in another form. A company trading in its own shares is not possible when the shares have to be cancelled after they have been acquired, as is the requirement in the United Kingdom or the new South African regulation. In the mid 1990's, the United States stock market was rising. Nevertheless, repurchase programs, from firms like Coca-Cola, IBM, and Philip Morris, were launched in the belief that stock would be worth more in the future.[35]

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[31] BREALY & MYERS, *Principles of Corporate Finance* 376 (4 ed. 1991).
[32] BRIGHAM & HOUSTON, *supra* note 23, at 571.
[33] *Supra* note 23, at 571.
[34] BLOCK & HIRT, *Foundations of Financial Management* 534 (8th ed. 1997).

3. Stabilising the Market Price

By repurchasing its stock, the company can maintain a constant demand for its own shares and possibly prevent further decline in the market price. This makes sense mainly, in the case of a stock market crash that is unconnected to the actual value of a firm.

In the USA, the crash of October, 1987 led to a flood of open market stock repurchase announcements.[36] Especially companies whose share prices had declined abnormally launched such programs.[37] For example, General Motors announced the repurchase of 64 million shares worth $ 4.72 billion.[38] Almost every company which announced stock repurchases profited from that announcement. The market price stabilised faster compared to firms which did not announce stock buybacks.[39] An important factor, leading to the stabilisation of the market price, is the announcement of the stock repurchase itself. This, again, can be put down to the signalling effect of such announcements. Add to this that not only is the market price stabilised but that an announcement of repurchase programs often lead to a higher excess stock return.[40] Empirical studies in the USA show that the different methods of acquiring stock reflect different performances of the market price. Concerning open market repurchases, the excess stock return increases by about 3 percent within three month after the announcement. Regarding fixed price tender offers, there is an average increase of 15 percent. In contrast a negotiated repurchase causes a drop in the excess stock return of about 4 percent, on average.[41]

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[35] BLOCK & HIRT, *supra* note 34, at 534.

[36] Netter & Mitchell, *Stock Repurchase Announcements and Insider Transactions after the October 1987 Stock Market Crash*, 18 FINANCIAL MANAGEMENT n. 3, 84 (1989).

[37] Comment & Jarrell, *supra* note 8, at 1246.

[38] *See* the table on page 535 in BLOCK & HIRT, *supra* note 34, about the biggest announced stock buybacks of 1987.

[39] *See* Netter & Mitchell, *supra* note 36, with an elaborate survey of the 1987 crash.

[40] Comment & Jarrell, *supra* note 8, at 1243 and 1253 with a comparative study of open market repurchases, self-tender offers and Dutch Auctions between 1984 and 1989 in the USA.

[41] *Compare* with more accurate data: Comment & Jarrell, *supra* note 8, at 1253 et. seq.

4. Increased Earnings per Share

Stock repurchases result in an increase of earnings per share for the remaining shares, because the repurchased shares usually do not participate in dividend payments. Assuming that managers hold shares in their company – as is regularly the case in the USA – an increased earnings-per-share ratio gives an incentive to act in the light of the shareholder value principle because managers would at the same time enrich themselves. Repurchased stock could also be used as a form of remuneration for management. This requires that the repurchased shares are held as treasury stock. In the United States, treasury stock is frequently used for executive stock option plans or employee stock options.[42]

5. Adjusting Equity Capital

A company with excess cash and no real investment opportunities may choose to repurchase its own shares. The president of Fuqua Industries, Inc. said: "Our earnings are good and rather than invest in something that we did not know anything about, we decided to buy some stock of our own company, which we do know something about".[43] The repurchase program can be used to produce "large scale changes in capital structures".[44] For example, Consolidated Edison – an American company – bought its own shares worth $ 400 million with loaned capital, in order to increase its debt ratio.[45] This dramatic change in Edison's capital structure could not have taken place as fast with any other restructuring method.

6. Future Acquisitions and Merger Transactions

A company may build up a substantial amount of own shares, and hold them as treasury stock, to use them for future acquisitions. It is rather uncommon to buy companies with cash. One possible method of buying a company is to pay the target company with the bidders own shares.[46] This method eliminates the necessity of issuing new shares which would dilute the shareholders' equity.

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[42] BRADLEY, *Administrative Financial Management* 350 (4th ed. 1979).
[43] Cited in BRADLEY, supra note 42, at 351.
[44] BRIGHAM & HOUSTON, *supra* note 23, at 571.
[45] BRIGHAM & HOUSTON, *supra* note 23, at 571.
[46] *Compare* BRADLEY, *supra* note 42, at 350.

Once shares are taken off the market, they could be reissued to targets as consideration for a merger. The usual procedure would have the effect of increasing the company's equity base. This bears the risk of decreasing the value of existing shares.[47]

7. Venture Capital

In case where repurchases are permitted, this would facilitate the financing of smaller firms by venture capital firms. Venture capital firms hold a large block of shares as security for loans to exiting, new companies. This means that in the beginning of the project, the venture capital firms are the dominant shareholder. Assuming the business works out well, the block of shares held by these venture capital firms could be repurchased by the company. This is especially important for shares which cannot easily be sold on the open market. There would also be less risk involved for the financier. It would open the stock exchange to smaller companies, and facilitate the gathering of capital, or the establishment of a whole new business.

B. Composition of the Shareholders

If the repurchase does not involve every shareholder on a pro rata basis, repurchasing shares directly influences the composition of the company's shareholders. Bearing that in mind, management could use the instrument of share repurchases to actively create a different composition of shareholders.

1. Share Repurchases as Defensive Tactics

The possibility of influencing the composition of shareholders allows management to thwart hostile bidders. Repurchases of own shares is an effective and commonly used defensive tactic. To defeat hostile tender offers, management can invoke preventive or defensive measures.

Preventive measure means that a stock repurchase program takes place at a time when there is no unsolicited bid on the table. In the literature, three rationales are given for preventive stock repurchase programs.

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[47] *Compare* McCabe, *The Desirability of a Share Buy-Back Power*, 3 BOND LAW REVIEW 115, at

Firstly, stock is repurchased with the intention of lowering the issuer's financial profile as a potential target.[48] This can happen through an increased earnings-per-share ratio, because of a reduction of the number of outstanding shares, in order to raise the price of the target's stock. The issuer will be more expensive, forcing the bidder to increase the offer or abandon it.[49] The goal can also be reached by improving the company's fiscal performance, employing a higher leverage rate or a higher return on stockholders' equity.[50] Management could also follow the opposite procedure by eliminating excess cash and increasing debt through repurchase programs. So-called 'bootstrap' acquisitions are supposed to be less attractive in such a case.[51]

Secondly, stock buybacks are employed to eliminate certain shareholders. If a large block of shares is in 'weak' or dissident hands, management tries to purchase these blocks to remove the threat of the stock falling into the hands of a hostile bidder.[52] The number of loyal shareholders increases, and it is more difficult for a potential bidder to gain stock as part of his acquisition strategy. In conclusion, shares are repurchased from those shareholders "who have the lowest opportunity costs of tendering".[53] When these shareholders are eliminated, the remaining shareholders assign a higher personal valuation to the stock, and are only willing to tender at a higher price.[54] In this way a potential takeover becomes more expensive. The success of buying back shares from those shareholders who assign a relatively low personal valuation to the stock, is dependant upon the chosen repurchase method. "In a prorated offer, management does not reap any control benefits in the sense of reducing the probability of hostile takeovers".[55]

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124 (1991).

[48] Nathan & Sobel, *supra* note 22, at 1546.

[49] Bradley & Rosenzweig, *Defensive Stock Repurchases*, 99 HARVARD LAW JOURNAL 1377, at 1378 (1986).

[50] *Compare* Nathan & Sobel, *supra* note 22, at 1546.

[51] Nathan & Sobel, *supra* note 22, at 1547 question the effect with an illustrative example: "An issuer has 5,000,000 outstanding shares, trading in the $ 20 range, and excess cash and credit of $ 20,000,000. Further assume that in an acquisition context the issuer's stock is worth $ 35. If the issuer were to use its cash and credit to repurchase 1,000,000 shares at market in an open market acquisition program, it will be saving the bidder $ 15,000,000 in acquisition cost and reducing the aggregate acquisition cost from $ 175,000,000 to $ 140,000,000, thereby potentially increasing the number of bidders with the wherewithal to make the acquisition". Therefore the only advantage will be the increased market price caused by the repurchase program.

[52] Nathan & Sobel, *supra* note 22, at 1551.

[53] Stulz, *Managerial Control of Voting Rights – Financing Policies and the Market for Corporate Control*, 20 JOURNAL OF FINANCIAL ECONOMICS 25, at 49 (1988).

[54] Comment & Jarrell, *supra* note 8, at 1241 and 1248.

[55] Kale, Noe & Guy, *supra* note 20, at 141 et seq.

Thirdly, a preventive repurchase program may increase the percentage of stock that is owned by management or management loyalists.[56] In the case of a share buyback it is obvious that this is coupled with an increase in the percentage ownership of a possible control group, by reducing the number of outstanding shares. In addition to that, management has the opportunity to sell the repurchased shares to management loyalists[57], that is to the very same control group, which would therefore profit twice. The higher the percentage ownership of a loyal control group, the higher the influence of this group regarding the outcome of a takeover bid. The concept is dependant on the ultimate loyalty of the control group. Possible control groups are trusts, families, charitable foundations, employees, management itself, or other friendly companies. But as Nathan & Sobel put it: "One must never forget that at some point every share-holder, no matter how strong his ties to the issuer, has a price at which he is willing to sell his stock".[58]

The given motives for preventive repurchases apply as well for defensive stock acquisition programs. Defensive stock repurchases are an immediate response to a particularly imminent or pending takeover bid. In addition to that, other purposes are inherent in defensive stock repurchases.

Greenmail is one way of keeping the bidder away, although it is a rather expensive way. Management and the potential bidder directly negotiate the conditions of the buyback. After this, the issuer repurchases the shares from the acquirer at a premium above the market price. On the other hand, the acquirer may promise not to engage in a hostile tender offer against the issuer[59] (so-called standstill agreements).

Another tactic is to discriminate the bidder in announcing a self-tender offer but denying the bidder to take part in it. The disadvantage is that the percentage owner-ship of the bidder will increase. On the other hand, there will be less cash available for the bidder. The target becomes unattractive. In combination with enhancing the percentage ownership of an existing control group, management can enter into a negotiated transaction with the dissident or weak shareholders.[60]

All in all, one can say that share repurchase programs, executed with the purpose of thwarting a hostile takeover, are the most enigmatic and controversial reason for

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[56] Bradley & Rosenzweig, *supra* note 49, at 1378.
[57] Stulz, *supra* note 53, at 44.
[58] *Supra* note 22, at 1556.
[59] Nathan & Sobel, *supra* note 22, at 1564.
[60] Nathan & Sobel, *supra* note 22, at 1563.

repurchases. This is reflected in the various legal systems, and is determined by the valuation of hostile takeovers. Some authors even go as far as to consider defensive or preventive buybacks as the "predominant purpose (if not the sole purpose) of the stock repurchase program".[61]

2. Decrease in the Number of Shareholders to Reduce Costs

It is in the interest of a company to minimize costs which are directly connected to the number of shareholders. One way to do that is to repurchase small shareholdings. Shareholder servicing costs, such as mailing dividend checks, annual and quarterly reports, proxy statements, other literature to shareholders or subscription rights can be reduced when the number of shareholders decreases.[62] An examinations of shareholder servicing costs in the USA concluded that a single shareholder results in costs of between $ 12[63] and $ 30[64] per year. This method is in particular attractive to smaller companies with widespread ownership of shares.

3. Closely Held Corporations

A restricted circle of shareholders, no market for the company's shares, and substantial majority shareholder participation in the management and operations of the business are typical for closely held corporations.[65] Discord amongst shareholders can result in immense problems which inevitably lead to liquidation of the company. To avoid this, share repurchases offer a solution to the problem. Dissident shareholders will be bought out by the company when the remaining shareholders do not have the financial ability. The problem in the case of death or retirement of one of the shareholders can be handled similarly. There might be a provision requiring the company to buy the stock of a deceased or retired shareholder. This allows the company to exclude unwelcome participants, and allows it to proceed with business with its most

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[61] Nathan & Sobel, *supra* note 22, at 1545.

[62] Bradley & Wakeman, *The Wealth Effects of Targeted Share Repurchases*, 11 JOURNAL OF FINANCIAL ECONOMICS 301, at 303 (1983).

[63] Which is the sum stated by Reyher & Smith, *An Overview of recent Trends in Corporate Stock Repurchases*, INDUSTRIAL MANAGEMENT 26 (July/August 1987).

[64] Which is the sum stated by Star, *Odd Lots Targeted*, PENSION & INVESTMENT AGE Volume 17 Number 14, 35 (1989).

[65] *Compare* for the United States: Donahne v. Rodd Electrotype Co. of New England, inc., 367 Mass. 578, 328 N.E. 2d 505, at 511 (1975); Estate of Schroer v. Stamco Supply, Inc., 19 Ohio App. 3d 34, 482 N.E. 2d 975, at 978-979 (1984).

preferred potential shareholders.[66] Furthermore, the remaining shareholders need not provide the money to buy the outstanding shares themselves.

4. Cross-Holdings

In continental Europe especially in Germany, it is very common for major companies in the financial sector, to hold large blocks of shares in many listed companies, and vice versa (cross-holdings). This is due to the fact that a repurchase of own shares was to a large extent illegal and only allowed in special situations. The companies defended themselves by seeking a friendly company to buy a block of shares, and in this way to prevent a hostile takeover. In the same way, the friendly company would ask for the same favour in return, for fear of a similar hostile takeover. Over the years, many companies got involved resulting in the whole corporate world becoming interwoven. This, in particular, is questionable, because management becomes more and more independent. One way to solve that problem is a buyback of own shares. Because too many shares held in cross-holdings are sold on the open market, this would inevitably lead to declining market prices and probably a stock market crash, if these shares could be sold at all.[67]

5. Going Private

Going private is when a controlling shareholder of a publicly held company buys all the outstanding shares, and thereby returns the company to private ownership.[68] Because the controlling shareholder already has the majority of the shares, it is not necessary for him to buy shares at his own expense. The easier way is by a repurchase of the company's shares. All other shareholders are eliminated until only the controlling shareholder remains. In the United States this procedure can occur in a coersive way. In a two step acquisition, the controlling shareholder starts with a tender offer, or discrete repurchases, followed by a merger with a dummy company.[69]

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[66] BLACK, *Corporate Dividends and Stock Repurchases* § 6.01 [2], 6-5 (1991).

[67] The Deutsche Bank AG announced that they want to get rid of their blocks of shares of KHD and Daimler Benz. They had to confirm that these blocks are de-facto unmarketable and took their announcement back.

[68] Iselin, *Regulating Going Private Transactions: SEC Rule 13 (e)(3)*, 80 COLUMBIA LAW REVIEW 782 (1980).

[69] *See* Gardner, *Company purchase of own shares under the Companies Bill 1990 – A sheep in wolf's clothing?*, 22 VICTORIA UNIVERSITY OF WELLINGTON LAW REVIEW 159, at 161 (1992).

One form of going private is the so-called management buy-out. The management reduces the outstanding shares until management with its own shares is the only remaining shareholder. This is done by way of either a tender offer to all or part of the shareholders, or by acquisitions through the open market. Assuming management had to buy all outstanding shares, they would hardly ever be able to finance the buy-out. But, by using repurchase programmes, they can substantially reduce the amount of capital they have to provide. This is especially the case when management buy-outs are combined with a leveraged buy-out, as was common in the 1980s in the States.[70]

III. RISKS AND DISADVANTAGES

Disadvantages in connection with the repurchase of own shares programs can be separated into four categories. The first group is concerned with disadvantages for creditors. Secondly, there is a risk for the company itself and, thirdly, repurchase programs can be disadvantageous for the shareholders. Finally, the problem of insider dealing and price manipulation can occur.

A. Risks for the Creditors

In 1887 the House of Lords[71] held that a limited company may not acquire its own shares, even though there may be an express power to do so in its memorandum. The decision was based, on one hand, on the fact that a repurchase would result in a reduction of capital. Lord Herschell stated that creditors of the company had a right to look to the paid up capital as the fund out of which their debts would be paid[72], and: "a right to rely on capital remaining undiminished by ... the return of any part of it to the shareholders".[73] Lord Watson expressed this in the following way: "Persons who deal with and give credit to companies rely on the fact that the company is trading with a certain amount of capital already paid... and are entitled to assume that no part of the capital will be paid out except in the legal course of the business".[74]

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[70] *See* the leading Delaware case: Weinberger v. UOP, Inc. 457 A.2d 701 (Del. 1983).

[71] Trevor v. Whitworth (1887) 12 App.Cas. 409.

[72] Trevor v. Whitworth, *supra* note 71, at 414.

[73] Trevor v. Whitworth, *supra* note 71, at 415.

[74] Trevor v. Whitworth, *supra* note 71, at 424.

Most commonwealth states followed that rule[75], but later on applied it less strictly or abandoned it totally. Civil law countries went the same way, as their concern with the various Companies Acts is mainly the protection of creditors and minority shareholders. One expression of the protection of the creditors is the requirement of maintenance of capital, adopted in almost every country.[76] Generally the capital yardstick represented by issued share capital cannot be reduced except under an order of the court, or other restrictive measures. Assuming that the purchased shares would be cancelled, and nothing would replace them, a repurchase of shares would always result in a capital reduction.[77] Unless a crisis occurs, there will be little immediate danger for the creditors even in the case of capital reductions. But, assuming a crisis occurs, the market price of the shares will crash. The equity capital thought of as the guaranteed capital for the creditors is lost. This is especially true when the repurchase was not financed out of distributable profits. The other potential danger was already pointed out by Lord Watson in *Trevor v. Whitworth*. Creditors give money to companies because they know that there will be a minimum guaranteed fund represented by the equity capital. Assume that a company, with an equity capital of $ 1,000,000, reduced its capital through repurchase of own shares to $ 500,000 (they bought shares equalling $ 500,000 of equity capital). Creditors who have given money to the company before the reduction of capital, find a totally different situation. Now half the previous sum of equity capital has to stand as a guarantee for the same amount of debt.

Another risk arises out of the theory of capital structure combined with limited personal liabilities. As already mentioned, a repurchase of own shares influences the capital structure of the company. The changed capital structure can lead to managers employing more risky financing practises, especially so-called debt financing. The debt financing gives equity holders an incentive to invest in more risky projects. "More specifically the debt contract provides that if an investment yields large returns, well above the face value of the debt, equityholders capture most of the gain. If, however, the investment fails, because of limited liability, debtholders bear the consequences".[78] The strategy is called 'going for broke' and benefits the equityholders. Generally speaking the risk of bankruptcy increases to a large extent.

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[75] *See* WROTTESLEY, *A Company's Repurchase of its own Shares* 3 (LL.M. Dissertation 1994 UCT).

[76] With the important exception of the United States.

[77] *Compare* DAVIES, *Gower's Principles of Modern Company Law* 248 (6th ed. 1997).

[78] Harris & Raviv, *The Theory of Capital Structure*, 46 JOURNAL OF FINANCE 297, at 301 (1991).

B. Risk for the Company

The repurchase of own shares can be a threat to the company itself. If a company buys its own shares in the time of a crisis, to prevent a crash on the stock exchange, then the used resources are lost for use in other projects. Furthermore, liquidity is decreased. There is the danger that the company will not be able to pay its debts. It is impossible for the company to sell the shares because this would lead to a further decrease in the market price and therefore this measure would be counter productive. Once in this dilemma, it is difficult for the company to emerge from it. The company is dependant on the performance of the market in general, and can little do to save itself. The impossibility of paying its debts may result in another decrease in the market price, to which the company cannot react because of the lack of capital. The ultimate result is winding up. To illustrate the procedure, one can look to the occurrences during the world economic crisis of 1929 to 1931.

The crisis started off in the USA. At this time the major companies in the financing sector of the United States provided foreign companies with credit. By virtue of the crisis they terminated their loan contracts and demanded their money back. The faith in shares, as a form of investment, was destroyed, which resulted in dramatic crashes on the European stock exchanges. In Germany, where share repurchases were common, large companies began to repurchase their own shares. They ended up with own stock representing more than half of the original equity capital. Because of the ongoing crisis, and the fact that the repurchases were not financed out of distributable profits, these firms broke down or had to be saved by the government.[79]

The situation where management decides to acquire the companies own shares, at the wrong time or for the wrong reason, is disadvantageous rather than risky. The market price could benefit more from paying a dividend than from a repurchase program. This will happen when shareholders are not indifferent between dividends and capital gains.[80]

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[79] Which in fact led to an enacting of general permission of share repurchase in Germany. Compare for the historic situation in Germany and Europe: WASTL, WAGNER & LAU, *Der Erwerb eigener Aktien aus juristischer Sicht – Herleitung und Entwicklung von Vorschlaegen fuer eine gesetzgeberische Reform* 75 (1997).

[80] BRIGHAM & HOUSTON, *supra* note 23, at 571.

C. Risks for the Shareholders

The first point to mention is the problem of unequal treatment of shareholders. This can occur in various forms.

An obvious case is greenmailing. One shareholder receives the opportunity to sell his shares at a premium from which all other shareholders are barred. More far-reaching is the situation where a shareholder owns a large share block and sells that block because he received information, from friendly management, about an imminent company crises. The shareholder escapes the situation without damage, whereas the remaining shareholders face huge losses, not at least because of the repurchase of the large block of shares.

Closely connected with the problem of a reduction of capital is that shareholders, who sell to the company are released from the shared risk of loosing their capital with the other shareholders. At first sight, it makes no difference to a shareholder whether he sells on the open market, or to the company. But, in fact in the latter case, the risk for the remaining shareholders has increased. In times of an economic crisis, there would not be enough equity capital to distribute to the remaining shareholders. Again, liquidity was used to distribute and is in a crisis not available for errands of mercy.

Wealth transfers from tendering to non-tendering shareholders take place when management, in a self-tender offer, chooses a premium too low or, after the announcement of an open market purchase, the shares still remain undervalued. In addition to this, selling shareholders may not be fully aware of all the implications and conditions of the repurchase, and may make an uninformed decision[81].On the other hand companies, may not pay premiums that are too high, thus disadvantaging the remaining shareholders.

Extensive share repurchase programs could result in an independent management. If management could exercise the voting rights connected with the repurchased shares, then the power of management would be enhanced and their position in the company entrenched. At the end of the day, management could control the company without ever having paid for the shares and without any personal risk. But even if they could not exercise out the voting rights, management could strengthen their position by paying out opposing shareholders and forming a loyal control group. The remaining shareholders are affected since they have little influence in the company's politics.

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[81] BRIGHAM & HOUSTON, *supra* note 23, at 571.

The possibility to influence takeover bids strengthen the management and management evades from the market for corporate control.

Although in case of closely held corporations share repurchases offer facilitations and advantages this is not without any risk involved. Because there is no market for such shares, majority shareholders are most likely to profit from allowing repurchases. The company may use its funds to buy back the shares of favoured shareholders at an attractive price, but deny this opportunity to minority shareholders. "Conversely the controlling shareholders may force a minority shareholder to sell out to the company or other shareholders at a bargain price, by destroying the value of the minority shareholder's investment. Usually accomplished by firing him from his positions and eliminating dividends".[82]

D. Insider Dealing and Price Manipulation

It was already established in *Trevor v. Whitworth* that trafficking is an unauthorised activity.[83] That was the second major reason besides, a reduction of share capital, to condemn share repurchases and therefore to prohibit them in general. The possibility of the company to buy, hold and sell its own shares, enables it to make profits, to manipulate the price, and to use information for transaction others have no access to. Management is closest to all information concerning the performance of the company and therefore it can make better informed decisions when trading in its own shares. Management may be tempted to conceal its own failure in manipulating the market price and saving their positions as directors. Share prices which provide a criterion for assessing management performance, are no longer an accuarate reflection of the firms accomplishments. Another major problem is that officers and directors who personally know about the situation of the company, could use share repurchase programs to their own personal advantage.[84] The insider dealing and manipulation problem becomes most obvious when management tries to buy out the shareholders in a so-called 'management buy out'. In such a case, all members of management are involved, and the consequence is that the purchaser is better furnished with informa-

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[82] BLACK, *supra* note 66, at § 6.09 [1], 6-118; so-called freeze outs.

[83] Lord Herschell, *supra* note 71, at 417.

[84] Comment & Jarrell, *supra* note 8, at 1249.

tion than the seller.[85] Experience in the United States shows that management does not hesitate to exploit an information advantage.[86]

III. Comparative study

A. Europe

1. European Union

In the European Union the praxis of acquiring own stock is widely determined by the Second Council Directive 77/91 of December 13, 1976. The Directive contains rules concerning the repurchase of own stock in Articles 19 to 24. The main question, whether the repurchase of own stock should be permitted at all, is left to the Member States to decide. Therefore, the rules only apply to those Member States which decided to permit the repurchase of own shares. The central provision is Article 19. A company may acquire its own shares when it obeys the following restrictions:

- authorisation shall be given by the general meeting, which shall determine the terms and condition of such acquisitions, and in particular the maximum number of shares to be acquired, the duration for the period for which the authorisation is given and which may not exceed 18 months, and, in the case of acquisition for value, the maximum and minimum consideration;
- the laws of a Member States may provide for derogations from the main rule that authorisation shall be given by the general meeting, where the acquisition of a company's own shares is necessary to prevent serious and imminent harm to the company and where the acquisition was made for distribution to the company's employees or to the employees of an associate company;

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[85] Judge Mahoney describes in Glandon Pty Ltd. v. Strata Consolidated Pty Ltd. (1993) 11 ACLC 895, at 899 the situation as follows: "...But it is clear that, because of their position as such, directors have or may have a substantial advantage over the shareholders with whom they deal. They have this advantage by reason of, as it has been described, "insider knowledge". They know things about the company, its assets and their potential, which are not shown by the company's published accounts or documents or otherwise and which would not be known by an ordinary diligent shareholder."

[86] Arber v. Essex Wire Corp. 490 F.2d 414 (6th Cir. 1974); Bruce v. Rosenberg 463 F.Supp. 673 (E.D. Wis. 1979); Rogen v. Ilikon Corp. 361 F.2d 260 (1st Cir. 1966).

- the nominal value of the acquired shares may not exceed 10 per cent of the subscribed capital;
- the acquisition may not have the effect of reducing the net assets below the amount of the subscribed capital plus those reserves which may not be distributed;
- the acquisition is restricted to only fully paid-up shares.

Article 20 provides for situations where Article 19 does not apply, e.g. shares acquired to reduce capital or as a result of a universal transfer of assets. When the company acquires shares in compliance with Article 19, they can be held as long as the company wishes. Shares acquired in the case of Article 20 must be disposed of within not more than three years of their acquisition date, unless the nominal value does not exceed 10 per cent of the subscribed capital. If the shares are not disposed within three years they must be cancelled.

Article 21 provides that shares acquired in contravention of Articles 19 and 20 shall be disposed of within one year of their acquisition. Should they not be disposed of within that period the shares must be cancelled.

Article 22 is concerned with the rights attached to shares after their acquisition. If the shares are not immediately cancelled upon acquisition. the right to vote is suspended.

Article 23 prohibits the company from advancing funds, making loans, or providing security, with a view to the acquisition of its shares by a third party.

The proposal for the 13th Company Law Directive concerning takeovers was originally contained an Article 8, which restricted repurchases of own shares in the case of an actual or imminent takeover bid.[87] The Article was cancelled a short time later. The 13th Directive has not come into force yet. The enactment-procedure is still pending.

2. United Kingdom

The general rule was established in 1887 by the House of Lords in *Trevor v. Whitworth*.[88] A company may not acquire its own shares, even if its memorandum authorises it, because it will either lead to trafficking or to an unauthorised reduction of capital. The rule has survived until today and is currently laid down in section 143 of

[87] Compare Abl. 1990, C 240/7.

the Companies Act of 1985.[89] In 1929 a commission under Greene came to the conclusion that companies did not repurchase their shares by themselves, because that was forbidden, but repurchased them through third parties. The company provided this friendly party with advance funds so shares could be purchased legally. Parliament enacted a prohibition of such transactions. The currently existing Article 23 of the Second Company Law Directive is based on this early British experience.

The general prohibition in section 143 is subject to several exceptions. Before I discuss those exceptions a recourse to the recent case of *Acatos & Hutcheson plc. V Watson*[90] needs to be mentioned. The plaintiff sought a declaration that (a) he had power to acquire the entire issued share capital of *Acatos Ltd* and (b) the prohibition against a company acquiring or dealing in its own shares does not apply. The plaintiff was a listed company on the London Stock Exchange whereas *Acatos Ltd* was a private company. The Hutcheson family owned all the shares of *Acatos Ltd* and a substantial amount of the shares of the plaintiff. The Hutcheson family wanted to take over the whole of the plaintiff. Pursuant to that, *Acatos Ltd* acquired 29,4 per cent of the voting share capital of the plaintiff which represented *Acatos Ltd's* sole asset. The intention of making an offer was abandoned, but became real again. The way it was supposed to work this time was by drafting an agreement which provided for the sale, by the Hutchesons, of the entire issued share capital of *Acatos Ltd* to the plaintiff. In exchange the Hutchesons would receive an issue of new shares in the plaintiff. Lightman J held that a company is not precluded by section 143 of the Companies Act 1985, or under the rule in *Trevor v Whitworth* , from acquiring the shares of another company in circumstances where the sole asset of the acquired company is shares in the acquiring company.[91] As judge Lightman points out himself[92], there is economically no difference between a situation where the plaintiff would have repurchased his shares directly, and the situation as it appears in the case. But the concern was that a different ruling would have provided target companies with a powerful defensive tactic. If the takeover of a target company were precluded by virtue of its holding shares in the acquiring company, the acquisition by the target company of such a holding would

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[88] *Supra* note 71.

[89] Section 143 (1): a company "shall not acquire its own shares whether by purchase, subscription or otherwise". Company in the aforementioned meaning is a public or private company, whether limited by shares or by guarantee if it has a share capital.

[90] [1995] 1 Butterworths Company Law Cases 218.

[91] Acatos & Hutcheson plc v. Watson [1995] 1 Butterworths Company Law Cases 218.

[92] Acatos & Hutcheson plc v. Watson [1995] 1 Butterworths Company Law Cases 218, at 221.

be an effective defence to such a takeover.[93] Whether this argument is indeed compelling is questionable, especially because the City Code on Takeovers and Mergers prohibits any frustrating action by the board, unless approved by the shareholders.[94] However judge Lightman also pointed out that the directors of the acquiring company have to fulfil their fiduciary duties, as well as having to act in the company's interest.[95]

A company is allowed to acquire its own shares provided they are fully paid up and that no valuable consideration is paid for them.[96] Acquisitions on an authorised reduction of capital are permitted under section 143 (3) (b). The redemption of redeemable shares (section 159), the purchase under a court order, and the forfeiture or surrender of shares are also allowed.[97] By far the most far-reaching exception is laid down in section 162 (compare section 143 (3) (a)). Section 162 provides that: subject to the following provisions, a company, if authorised to do so by its articles, may purchase its own shares (including redeemable shares); that sections 159 and 160 apply as they do to redemptions; but that a repurchase cannot be made if, as a consequence, only redeemable shares would remain in existence. In *Re R W Peak (Kings Lynn) Ltd,* Lindsay J held that a written contract to purchase a companies own shares cannot be regarded as an effective alteration of the articles and an authorisation at the same time.[98] In that case the company's articles did not contain a clause enabling the company to buyback its own shares. In addition to that, there were no resolution passed which authorised the company to repurchase its own shares before the contract was entered into, as section 164 (2) of the Companies Act 1985 requires. The only thing the members of the company did was sign the repurchase contract.

Section 162 (2), in connection with section 160 (4) and (5), determines the status of repurchased shares. They have to be cancelled. In comparison in the USA they usually do not need to be cancelled, and even the Second Company Law Directive does not require the member states to provide for a cancellation. As a consequence, the issued share capital diminishes by that amount. This very strict position was

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[93] Acatos & Hutcheson plc v. Watson [1995] 1 Butterworths Company Law Cases 218, at 224.
[94] *Compare* General Rule 7 and Rule 21 of the City Code on Takeovers and Mergers.
[95] Acatos & Hutcheson plc v. Watson [1995] 1 Butterworths Company Law Cases 218, at 225.
[96] Section 143 (3) Companies Act 1985. Regarding the question whether a valuable consideration was paid for shares: Vision Express (UK) Ltd v Wilson and another [1995] 2 Butterworths Company Law Cases 419, at 424 et. seq. No valuable consideration is paid, if shares are given as a gift to the company.
[97] Section 143 (3) (d) Companies Act 1985.
[98] [1998] 1 Butterworths Company Law Cases, 193, at 202.

precipitated by the fear of trafficking, as established early on in *Trevor v. Whitwarth.*[99] This position enabled the British legislator not to implement the 10 per cent restriction, as given by the second European Directive. All but one share can be repurchased. Since the shares cannot be sold afterwards because they will be cancelled, no trafficking can occur. Trafficking was one purpose for the European Union to set the 10 per cent restriction. Despite this, the rule that a company should not be allowed to purchase more than 10 per cent of its own shares should also serve as a restriction on repurchases as defensive tactics and a restriction to influence-possibilities concerning the composition of shareholders. Because of that, it is questionable whether Britain acts within the boundaries of the Directive.

However, repurchased shares may be replaced by a fresh issue of shares.[100] It follows than, that the purchase of own shares can be financed by a fresh issue of shares, or out of distributable profits. In case of private companies, other ways of funding the repurchase are stated in sections 171 to 177. Private companies are empowered to buy back their own shares without maintaining the capital yardstick, mainly because otherwise there would be no possibility for such companies to buy back shares at all. Profits are usually not retained within the company and therefore repurchases have to be made out of capital. Any acquisition in breach of section 143 is void, and the company and every officer who is in default are liable to a penalty.[101] The procedure to be followed on a purchase under section 162 depends upon whether it is a market or off-market purchase. One should notice that, as it appears from *Re R W Peak (Kings Lynn) Ltd,* statutory procedures cannot be waived by the existing members of the company. This is because the procedure does not only serve the purpose of protecting minority shareholders but also of protecting creditors.[102]

a) Off-Market Purchases

Section 163 (1) defines an off-market purchase as a purchase made which is not on a recognised investment exchange, or a purchase not subject to a marketing arrangement when purchased on a recognised investment exchange. Off-market purchases can be conducted by every private or public company, no matter whether it

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[99] The rationale stated by Davies, supra note 77, at 254 that accounting and tax complexities are responsible for the restriction cannot convince since European Directives as well as solution in other countries provide tools to solve those problems.

[100] PALMER'S COMPANY LAW, Volume 1, 6.408 (25th ed. 1992, updated) .

[101] Section 143 (2) Companies Act 1985.

is listed on the stock exchange or not. That means that British law generally permits negotiated purchases even when the company is dealing with one shareholder exclusively. Because of the governing rules of the stock exchange, market purchases create fewer risks than off-market purchases. The potential for abuse is greater in transactions between individual shareholders and the company, than in market purchases. Therefore the procedure governing the off-market purchases is more detailed and more restricted. This provides for the equal treatment of shareholders.

Principally, off-market purchases have to be authorised with a special resolution by the general meeting.[103] The terms of the purchase contract have to be provided by management so that the general meeting can make an informed decision. The other alternative is a previously authorised contingent purchase contract under section 165. According to section 164 (3) the authority may be varied, revoked or from time to time renewed by special resolution of the company. In case of a public company, the authority conferred by the resolution must specify a date within 18 months on which the authority is to expire.[104] A holder of shares, which are the subject of a proposal to purchase them, will invalidate the resolution if he votes, and the resolution would not have been passed if he had not so voted.[105] Notwithstanding anything in the company's articles, any member of the company may demand a poll on the question whether any such resolution shall be passed.[106] Nevertheless the prospective vendor can exercise his voting rights on a poll in respect of other shares he may hold.[107]

The resolution will also be void unless a copy of the contract or a memorandum of its terms is available for inspection at the company's registered office for not less than 15 days before such a meeting for inspection is held.[108] Any such memorandum of contract terms must include the names of any members holding shares to which the contract relates, and a copy of the contract must be annexed to it a written memorandum specifying any such names which do not appear in the contract itself.[109] The same requirements apply to a resolution to approve any variation of the contract.[110] In

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[102] [1998] 1 Butterworths Company Law Cases, 193, at 203-204.
[103] Section 164 (2) Companies Act 1985.
[104] Section 164 (4) Companies Act 1985.
[105] Section 164 (5) Companies Act 1985.
[106] Section 164 (5)(b) Companies Act 1985.
[107] PALMER'S, *supra* note 100, at 6.411 and see Clemens v. Clemens Bros Ltd [1976] 2 All E.R. 268.
[108] Section 164 (6) Companies Act 1985.
[109] Ibid.
[110] Section 164 (7) Companies Act 1985.

Western v. Rigblast Holdings Ltd[111] it was held that an agreement between the company and a shareholder for the purchase of his shares is not enforceable until it has been sanctioned under section 164. A contract entered into without following the appropriate procedure according to section 164 is void.[112]

Section 165 provides for an alternative to the section 164 procedure. This is by way of a contingent purchase contract. This does not amount to a contract to purchase shares, but is a contract under which the company may become entitled or obliged to purchase those shares. This is also a form of a negotiated repurchase. The company can either issue true call options or put options, or an option which combines features of call and put options. A special resolution before the contract is entered into is compulsory[113], similar to the procedure in section 164. In practice, contingent purchase contracts are widely used to bind or entitle the company to purchase the shares of a director or employee when his employment ends.[114]

b) Market Purchases

Section 166 provides for the procedure for market purchases. According to section 163 (3) a market purchase is made on a recognised investment exchange other than a purchase which is an off-market purchase.

The general rule in section 166 (1) is in accordance with the Second Company Law Directive: A company shall not make a market purchase of its own shares unless the purchase has first been authorised by the company in a general meeting (ordinary resolution is sufficient). The authorisation may be general or limited to the purchase of shares of any particular class or description, and may be unconditional or subject to conditions. But, as the Directive requires, the authorisation must specify the maximum number of shares sought after, as well as the maximum and minimum price which may be paid for the shares, and it has to specify the date of expiry which must not be later than 18 months after the passing of the resolution.[115]

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[111] 1989 Green's Weekly Digest 23-950 (SC).

[112] BOYLE & SYKES, *Gore-Browne on Companies*, Volume I, 13.8.3; 13.020 (44th ed. 1986 supplement 30).

[113] See sections 165 (2) and 164 (3) and (7) Companies Act 1985.

[114] *Compare* DAVIES, *supra* note 77, at 256.

[115] Section 166 (3) (a) to (c) and (4) Companies Act 1985.

c) Disclosure Requirements

Section 169 provides rules for every type of buybacks. Certain information must be disclosed to the Registrar of companies. Within 28 days of delivery to the company, all companies must deliver a return to the Registrar of its own shares purchased. The return has to contain the number and nominal value of each class of shares acquired, and the date on which they were delivered to the company. For public companies section 169 (2) provides that the return shall also state the aggregate amount paid by the company for the shares, and the maximum and minimum prices paid in respect of each class purchased. If an officer defaults on delivery, he is held liable and will be finde.[116] In addition to that section 169 (4) requires the company to keep a copy of the contract concerning every repurchase of own shares for at least 10 years at its registered office. The copy must be open to public inspection without charge.[117] Private companies need only allow its members the right of inspection.[118] In case of a public company the contract must be available for inspection for no less than two hours on each business day, and permit the inspecting person to copy it by transcription or the taking of notes.[119] By refusal of an inspection the court may by order compel an immediate inspection of the copy.[120] In addition to that officers and the company are liable to fine when they refuse inspection.[121]

d) Additional Safeguards

Besides the Companies Act, the Listing Rules of the London Stock Exchange provide for additional disclosure requirements. Companies which want to purchase their own shares within the meaning of section 163 of the Companies Act 1985, and which are listed on the London Stock Exchange, have to give notice about proposed and actual purchases. According to chapter 15.3 of the Rules, any decision by the board to submit a proposal to shareholders for the company to be authorised to purchase its own equity shares, other than the renewal of an existing authority must be transmitted to the Company Announcements Office without delay. This must indicate whether the proposal relates to specific purchases, or to a general authorisation to make pur-

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116 Section 169 (6) Companies Act 1985.
117 Section 169 (5) (b) Companies Act 1985.
118 Section 169 (5) (a) Companies Act 1985.
119 Companies Regulations 1991 (Inspection and Copying of Registers, Indices and Documents); S.I. 1991 No. 1998, issued under section 723A.
120 Section 169 (8) Companies Act 1985.
121 Section 169 (7) Companies Act 1985.

chases. The outcome of the shareholders' meeting must also be transmitted to the Company Announcement Officer without delay. In keeping with the above, notice must also be given of any purchase of the company's own shares by, or on behalf of the company to the Company Announcements Office as soon as possible. This notice should certainly occur no later than 8.30am on the business day following the calendar day on which dealing occurred. The notification must include the date of the purchase, the number of shares purchased and the purchase price for each, or the highest and lowest price.[122]

Chapter 15.6 of the Rules requires that unless a tender or partial offer is made to all holders of the class of securities on the same terms, purchases by a company of less than 15 per cent of any class of its equity shares, pursuant to a general authority granted by shareholders, may be made through the market only if the price to be paid is not more than 5 per cent above the average of the market values of those shares for the 5 business days before the purchase is made. On the other hand, purchases of 15 per cent or more of its shares must be made by way of either a tender or a partial offer to all shareholders.[123] A stated maximum price or a fixed price must be given, and notice of the offer must be given by advertisement in two national newspapers at least seven days before the offer closes.[124] This was implemented to guarantee the equal treatment of shareholders when substantial stakes are to be repurchased. A shift of power to one specific shareholder can be avoided.[125]

Due to a regulation in the City Code on Takeovers and Mergers, the use of repurchases as a defensive tactic is limited. The City Code applies to all public companies whether listed or not, and to private companies which meet certain criteria.[126] General Principle 7 of the Code prohibits frustrating actions effected by the board of directors unless approved by the general meeting. Rule 21, in connection with rule 37.3 of the Code, provides explicitly that during the course of a takeover offer no redemption or purchase by the offeree company of its own shares may be effected, except in pursuance of a contract entered into earlier, without the approval of the shareholders at a general meeting. The same applies to situations where the board of the offeree company has reason to believe that a bona fide offer might be imminent. The invitation for the general meeting must include information about the offer or anticipated

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[122] Para 15.9 of the Listing Rules of the London Stock Exchange.
[123] Para 15.7 of the Listing Rules of the London Stock Exchange.
[124] Para 15.8 of the Listing Rules of the London Stock Exchange.
[125] *Compare* DAVIES, *supra* note 77, at 256.
[126] Introduction 4 of the City Code on Takeovers and Mergers.

offer. The procedure of buying back own shares is accompanied by certain disclosure obligations. Rule 8.1 of the Code provides that dealings in relevant securities by an offeror or the offeree company during an offer period, must be publicly disclosed. According to Rule 37.3 (b) and 37.4 (a) of the Code, relevant securities include the redemption or purchase of a company's own shares. Although the Code does not have the force of the law, it is widely recognised, and non-compliance with the Code would result in sanctions and the withholding of the facilities of the securities markets.

3. Germany

The tendency in the 1860's to speculate with the company's own shares caused the German government, the first in Europe to take such action, to prohibit any transaction with own shares.[127] Because of continuous criticism that the regulations were too restrictive, there was a change in 1884.[128] Article 215 had its wording changed from 'must not' to 'may not'. In fact, the applicable restriction received hardly any notice, and companies started to buy their own shares in their regular course of business.[129] In the 1920's and 30's, almost every company, especially banks, bought their own shares excessively. When the stock exchange crash in the summer of 1931 occurred, some of the large financial institutions bought more than half of their own shares back, and ended up by either winding up, or being rescued by the state.[130] In September 1931, the general prohibition was revived with one important exclusion: in case the repurchase of own shares is necessary to prevent serious and imminent harm to the company.[131] In any case, every purchase was restricted to a limit of at most ten per cent of the shares representing, the subscribed capital.[132] The general restriction of 1931 was into force until 1998. Just a few exceptions were added in over 60 years. For example, acquisitions for employee benefit plans or in special situations concerning a reorganisation of the company. The management had the power to decide whether or not to repurchase shares, but in the event of preventing serious and

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[127] Article 215 (3) of the "Gesetz betreffend die Kommanditgesellschaft auf Aktien und die Aktiengesellschaften" from July 1, 1870: "Die Aktiengesellschaft darf keine Aktien erwerben".
[128] Article 215 d (1) of the "Aktiennovelle of the 18. July 1884: Die Aktiengesellschaft soll eigene Aktien im geschaeftlichen Betriebe ... weder erwerben, noch zu Pfande nehmen".
[129] *Compare* Nussbaum, *Acquisition by a Corporation of its own Stock*, 35 COLUMBIA LAW REVIEW 971, at 974 (1935).
[130] Nussbaum, *supra* note 129, at 973
[131] §§ 226,227 der Verordnung des Reichspraesidenten ueber das Aktienrecht, die Bankaufsicht und Steueramnesie vom 19. September 1931: Die Aktiengesellschaft darf eigene Aktien erwerben, wenn es zur Abwendung eines schweren Schadens von der Gesellschaft notwendig ist.
[132] Nussbaum, *supra* note 129, at 975, fn. 20.

imminent harm to the company, the general meeting had to be informed about the rationale and the number of shares repurchased. There were no rights flowing from the shares possessed by the company but, when the shares were sold again, the attached rights revived.

Because of constant pressure from management and leading economists, as well as considerations regarding the international competition of market places, Germany enacted a revised section concerning the repurchase of own shares. Since 1 May, 1998, the new section 71 of the Stock Corporations Act (Aktiengesetz) came into force. 22 years after the Second Company Law Directive provided the possibility, Germany decided to make use of it. The provisions are within the given boundaries of the Second Company Law Directive. With the approval of the general meeting, management is allowed to buy back own shares.[133] Although no special reason is necessary, management still has to provide a rationale for the repurchase. Speculation with own shares is prohibited.[134] The maximum and minimum consideration for shares sought after have to be fixed, and the boundary of 10 per cent as the maximum amount of repurchased shares prevails. Every repurchase program has to be measured against the 'equal treatment of shareholders' rule laid down in § 53 (a) Aktiengesetz. Bearing this in mind, it seems to be that an offer must be made to all shareholders. Greenmailing is therefore prohibited except for the situation where the repurchase is necessary to prevent serious and imminent harm. The wording of § 71 (1) Nr. 8 Companies Act provides that open market purchases are a legitimate method to assure equal treatment of shareholders. In case the repurchased shares are sold again, the shareholders have the option to buy them. That means that any shares resold have to be offered to the shareholders first, and if they reject the offer, they can be sold on the open market. Should management decide to sell the shares on the stock exchange, approval by the general meeting with a special resolution is necessary. The general meeting can authorise management to cancel the repurchased shares.[135] No special provisions were made concerning defensive tactics. It appears to be that share repurchases as a defensive tactic are generally permitted. The company has to give notice to the observation body of the stock exchange (Bundesaufsichtsamt fuer Wertpapierhandel) immediately after the authorisation is given by the general meeting to repurchase own shares.[136]

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[133] § 71 (1) Nr. 8 (1) Aktiengesetz.

[134] § 71 (1) Nr. 8 (2) Aktiengesetz.

[135] § 71 (1) Nr. 8 (5) Aktiengesetz.

[136] § 71 (3) Aktiengestz.

The official reasons for implementing the new rules are: German law has to be adjusted to international standards, and the new rules facilitate a capital restructuring of companies. The critical period on the stock exchanges, especially in the end of 1997, showed that there is no longer a separation of the stock exchanges. German Companies are somewhat dependant on the development of the international markets and therefore should receive the same prerequisites for financing and managing as in other countries. Closely held corporations have the option of an easy change of shareholders. The implementation of the new provision received an immediate response. Within the first six months after the implementation, 63 listed companies received the authorisation of the shareholders to buyback their own shares. Schering AG was the first company under the new rules to actually repurchase own shares.[137]

4. France

As in most other countries of the European Union France also prohibited the repurchase of shares in general. For limited purposes, like cancellation of shares by special resolution of the general meeting, the allocation of shares to employees as part of a share participation scheme and, in case of companies quoted on the stock exchange, for the purpose of moderating the market price under special circumstances, share repurchases were permitted.[138] In accordance with the second Company Law Directive, the nominal value of the acquired shares may not exceed 10 per cent of the subscribed capital. But, in addition to that, France also imposed the 10 per cent rule to a certain class of securities. The acquisition has to be financed out of distributable profits. In case of an acquisition to moderate the market price, authorisation must be given by the general meeting which determines the conditions of the buyback.

In July 1998 France passed a law relating to economic and financial matters.[139] The provisions concerning the repurchase of shares came into force on 1 January, 1999.[140] Every repurchase is now subject to the prior preparation of a report by the company's auditors, which must be communicated to the shareholders within the

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137 *See* FRANKFURTER ALLGEMEINE ZEITUNG, December 9, 1998, Wirtschaft 22.

138 Articles 217, 217-1 and 217-2 of Law No. 66-537 of July 24, 1966.

139 Law No. 98-545 of July 2, 1998, published in the Official Journal on July 3, 1998. A general overview about the new regulation in English is available from Omar, THE COMPANY LAWYER, Volume 20, Number 2 February 1999, 62.

140 Law No. 98-545, article 49.

period allowed for by decree.[141] The general prohibition is now only applicable to subscriptions by companies to their own shares. Shares affected by repurchase programs are no longer entitled to carry voting rights at general meetings. The three former exceptions to the general prohibition are still the main categories of share buybacks. The only difference is that they are not subject to special conditions. Cancellation of shares with the approval of the general meeting (with special resolution) is allowed without any restriction.[142] The same can be said for the allocation of shares to employees as part of a share participation scheme.[143] The new rules provide for greater flexibility concerning the reasons for buybacks. Moderating the market price is no longer the only possible rationale. Shares may be repurchased for subsequent distribution to employees, or they may be cancelled subject to a maximum representing 10 per cent of the capital within a two-year period. The general meeting may authorise management to purchase any amount of own shares, not exceeding 10 per cent of the total amount of shares, within 18 months after the resolution. The resolution has to mention the method and the purpose of acquiring own stock, and the number of shares sought after. Management must provide the body representing the employees with a copy of the resolution. As part of meeting the necessary disclosure requirements, the company is obliged to keep the relevant regulatory body, responsible for the transaction made, informed on a monthly basis of all share transactions carried out in accordance with the resolution.[144] Purchases through an intermediary remain prohibited unless he meets the standard as a provider of financial services within the meaning of the law governing financial sector reform.[145]

5. Italy[146]

The regulation in Italy is of special interest because Italy was one of the first European states which implemented the second Directive and added some unusual safeguards. The Italian companies act was reformed in 1986. It is noteworthy that

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[141] Article 215 (2) of Law No. 66-537, as modifies by article 41 (1) (1) of Law No. 98-545. According to Omar, *supra* note 139, at 64 fn 4 it is expected, in line with the Stock Exchange Commission's recommendations, that this will be 15 days.

[142] Article 217 (2) of Law No. 66-537, re-enacted as Article 217 –1A by Article 41 (1) (3) of Law No. 98-545.

[143] Article 217-1 of Law No. 66-537, amended by Article 41 (1) (4) of Law No. 98-545.

[144] Article 217-2 of Law No. 66-537, reworded by Article 41 (1) (5) of Law No. 98-545.

[145] Article 217 (II) of Law No. 66-537, inserted by Law No. 98-545, Article 41 (1) (2), referring to Law No. 96-597 of July 2, 1996.

[146] *Compare in general for the Italian regulation*: WASTL, WAGNER & LAU, *supra* note 79, at 103 et seq.

before the second Directive was implemented, a repurchase of shares was permitted with even fewer restrictions than demanded by the Directive.

The initial situation is described in Article 2357 Codice Civile. A public company is allowed to acquire up to 10 per cent of its stock. But the procedure has to comply with the following restrictions. According to Article 2357 (1) the shares must be fully paid and the acquisition has to be done out of distributable profits. This is the same as in all the other European countries due to the rule of capital maintenance. The general meeting has to authorise the repurchase with the usual prerequisites laid down in the Directive.[147] Shares which were acquired on a permitted procedure, other than the prescribed one, have to be resold within one year. The general meeting decides upon the form of sale. If a sale fails to take place within one year, the shares have to be cancelled.[148] Shares acquired by the company do not carry any voting rights. The subscription rights of the repurchased shares will be proportionally added to the remaining shares. Nevertheless, the voting rights will be taken into account for the calculation whether a general meeting is able to pass a resolution.[149] This avoids the situation where groups of shareholders are able to block resolutions because they do not attend general meetings. This danger can only occur where the legislation provides for a minimum percentage of shareholders present in general meetings or with respect to the particular presence of voting rights. Italy was, as far as I can see, the first country which also required that the general meeting has the power to decide what will happen to the repurchased shares. Management has no opportunity to sell the shares without the approval of the general meeting. This prevents, to a large extent, the situation where management is able to create a friendly group of shareholders to the disadvantage of the "remaining" shareholders. Even in the event of the 10 per cent restriction, there may be a tactic whereby management secures their position in purchasing and selling the company's shares. Nevertheless, this rule is still under discussion because it prevents some advantages of trading with own shares, and leaves management inflexible.[150] Articles 2428 (2) (3) and (4) and 2424 B III 4 require the company to disclose purchases in the annual financial statement and the balance sheet.

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[147] Article 2357 (2) Codice civile.
[148] Article 2357 (4) Codice civile.
[149] Article 2357 (2) Codice civile.
[150] JAEGER & DENOZZA, *Appunti Diritto Commerciale*, Volume I (Impressa e Societa) 301, at 302 (3ed 1994).

Article 2357 states that the requirements stated above do not have to be complied with when the company does not use its own financial resources for acquiring shares, or when shares are repurchased to reduce the company's capital (in the latter the usual procedure of capital reductions have to be complied with). This is because the rule of capital maintenance is not concerned with that kind of acquisitions.

It seems that any frustrating actions, during a pending takeover offer, are prohibited. That would include the repurchase of shares during that period.[151] Bearing that in mind, the recent developments regarding the takeover bid from *Olivetti* for *Telecom Italia* are doubtful. The board of *Telecom Italia* wanted the shareholders to approve a 10 percent share buyback as one of many measures to thwart *Olivettis'* takeover bid.[152]

6. Other European Union Countries[153]

It is worth noting that, although the second European Directive dates back to 1976, most of the European Union countries did not pay attention to the subject until very recently. In a struggle to promote their countries as attractive locations for foreign and domestic enterprises, it seems that nobody wants to fall behind. Companies' Acts were renewed and amended, and almost every country chose a more liberal approach to the subject matter of share buybacks.

Austria changed its laws in 1996 and implemented a regulation similar to the German ones and very closely connected to the wording of the second European Directive.

Belgium reformed its laws in 1995. Provided the authorisation of the general meeting is given, the *société anonyme* is allowed to acquire its own shares. This takes place either via an open market purchase or an allocation to all shareholders of rights to sell their shares.[154]

Finland deviates from the 10 per cent restriction of the Directive. It allows the companies to buy back just 5 per cent of the outstanding shares.

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[151] P. Conci & S. Conci, *Takeover Bids in Italy*, 17 COMPARATIVE LAW YEARBOOK OF INTERNATIONAL BUSINESS 54, at 61 (1995).

[152] http://www.cnnfn.com/worldbiz/europe/wires/9904/04/olivetti_wg.

[153] *Compare in general*: Skog, *Der Erwerb eigener Aktien: Reformbestrebungen in den EU-Mitgliedstaaten*, ZGR 306, at 314-318 (1997).

[154] Article 21 bis Wetboek van Koophandel.

Denmark, Greece, the Netherlands, Portugal, and Spain all revised their Companies' Acts and adopted, more or less, the provisions of the Directive. Sweden, however, still has to implement a proposal which would bring its regulations in line with the other states.

B. United States of America

The United States sought to abolish the rule in *Trevor v. Whitworth* as early as 1906.[155] The jurisdiction to regulate corporate law lies with the states. They have enacted different legislation and it is therefore necessary to review not only federal law, but also state law. Nevertheless, the Model Business Corporation Act is the basis for many State Companies Acts.

1. Model Business Corporation Act

The pre-1980 Model Business Corporation Act of 1971 provides in § 6 that purchases must be made out of unreserved and unrestricted earned surplus. A majority of voting shares can authorise the corporation to make a purchase to the full extent of the capital surplus. The articles of incorporation can also provide for this facility. There are four exceptions where any repurchase does not necessarily have to be made out of a surplus: to eliminate fractional shares; to collect or compromise corporate indebtness; to pay dissenting shareholders entitled to payment for their shares, and to retire redeemable shares. No shares are allowed to be repurchased if the corporation is unable to pay its debts as they become due, in the usual course of its business, or if the repurchase would render the corporation insolvent.[156] Shares can be held as treasury shares which means they could be resold or they could be cancelled.[157] A cancellation of shares would amount to a capital reduction. When shares are held as treasury stock, the amount of used surplus is restricted until they are sold again. The MBCA also provides that directors of the corporation will be jointly and severally liable in any case where they supported an illegal purchase.

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155 Re Castle Braid Co. Ltd. 145 Fed. 224 at 231-233 (D.C. S.D.N.Y. 1906).

156 §§ 6, 66 MBCA 1971.

157 § 68 MBCA 1971.

2. Revised Model Business Corporation Act

The MBCA was the basis for the Revised Model Business Corporation Act. Nonetheless, the MBCA is still applicable law in many states. In the revised Act, share repurchases are equalled to the payment of dividends, both as forms of distribution to shareholders.[158] Subsequently the same rules apply to both forms of distribution. Once shares are repurchased they can no longer be held as treasury stock. Acquired shares revert to the status of authorised but unissued shares. In case the certificate of incorporation prohibits the reissuance of shares, the number of authorised shares is reduced by the number of acquired shares.[159] The new test to repurchase shares is no longer related to stated capital and surplus, but only to a certain solvency test.[160] If a corporation, after acquiring shares, is not able to pay its debts as they become due in the usual course of business, then the RMBCA prohibits the transaction.[161] The corporation's total assets remaining after the repurchase must at least equal the sum of its total liabilities, plus the amount that would be needed if the corporation were to be dissolved at that time. This amount is required to satisfy the preferential rights, upon dissolution, of shareholders rights which are superior to those receiving the distribution.[162]

3. Delaware Law

The most important state law is probably that of Delaware. Most American corporations are registered in Delaware because of the attractive corporation law in Delaware. Over the years, the courts in Delaware have developed into corporation law specialists, and federal law and other state laws are influenced by these decisions. Delaware permits repurchases out of any surplus. But purchases or redemptions are prohibited when the capital is impaired, or when the transaction would cause the impairment of capital.[163] In *In re International Radiator Co.*[164], the court held that impairment of capital meant "the reduction of the amount...represented by the aggregate outstanding shares of the capital stock...In other words, a corporation may use only its surplus

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[158] § 1.40 (6) RMBCA.

[159] § 6.31 RMBCA.

[160] That is the modern approach, also applicable in California, whereas the two other important state laws concerning company law – New York and Delaware - are still on the basis of surplus.

[161] § 6.40 (c)(1) RMBCA.

[162] § 6.40 (c)(2) RMBCA. The latter is subject to the articles of incorporation which can permit otherwise.

[163] DELAWARE CODE ANN. tit. 8, § 160 (a)(1) (1983).

[164] 92 A. 255 (Del. Ch. 1914).

for the purchase of shares of its own capital stock...The funds and property shall not be used for the purchase of shares of its own capital stock when the value of its assets is less than the aggregate amount of all its shares of capital stock." This is now laid down in section 154 of the Delaware General Corporate Law, which defines that funds used in the repurchase, exceeding the amount of the corporation's surplus, means the excess of net assets over the par values of the corporation's issued stock. The Delaware Superior Court held, in *Klang v Smith's Food & Drug Centers Inc.*[165], that balance sheets are not conclusive indicators of surplus and that corporations may revalue assets to show surplus, "but perfection in that process is not required."[166] In addition, directors can depart from the balance sheet to calculate surplus, so long as they evaluate assets and liabilities in good faith, on the basis of acceptable data, by methods believed to reflect present values, and arrive at a determination that is not so far off the mark as to constitute actual or constructive fraud.[167] The shares can be either retired or held as treasury stock. Retired shares become authorised and unissued shares. A reduction of capital is only allowed when the remaining assets of the corporation are sufficient to pay any corporate debts for which payment has not been otherwise provided.[168]

Certain disclosure duties arise under Delaware law. The board of directors owe a duty of complete candor to the stockholders, requiring them to disclose all material information in their possession.[169] The information has to be complete and, funny enough, not necessarily adequate.[170] The alleged omission or misrepresentation must carry a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.[171]

a) Business Judgment Rule

An important difference to the laws of most other states in the world is that the decision to acquire own stock is within the discretion of the board of directors. Usually no authority has to be granted by the general meeting. The directors are almost free in

[165] 702 A.2d 150 (Del. 1997).
[166] Klang v. Smith's Food & Drug Centers Inc., 702 A.2d 150, at 152.
[167] Klang v. Smith's Food & Drug Centers Inc., *supra* note 166, at 152.
[168] DELAWARE CODE ANN. tit. 8, § 244 (b).
[169] Cottle v. Standard Brands Paint Co., LEXIS 40 (Del. Ch. 1990).
[170] Lynch v. Vickers Energy Corp., 383 A.2d 278, at 281 (Del. 1977).
[171] Brody v. Zaucha, 697 A.2d 749, at 753 (Del. 1997).

their decision. The role of the business judgment rule is crucial.[172] Generally speaking if the purpose of the repurchase program is not concerned with maintaining control, the decision is made by using the business judgement rule.[173] On the other hand, if the purpose of the decision is to thwart a takeover attempt, then certain limitations apply to the business judgment rule.[174] Only when the directors acted merely to entrench their positions in the corporation, the business judgment rule does not apply.[175]

In *Grobow v Perot*[176], General Motors bought all of Ross Perot's stock at a premium. In return, Perot agreed to resign from the General Motors Board, stop publicily criticizing General Motors' management, not to purchase General Motors stock (standstill agreement) and not to wage a proxy fight against the General Motors Board. The Delaware Superior Court held that the plaintiffs failed to allege facts that would result in a reasonable doubt of director's financial self-interest, entrenchment or lack of due care. Since there was no outside threat to general Motors' corporate policy, because Perot did not hold enough stock and he also did not threaten a battle to take control, a decision by the board of directors presumed that the business judgment rule applies.[177] That implies that greenmailing is generally permitted, and that a corporation's repurchase of own shares from a dissident shareholder at a premium is actually protected by the business judgment rule.

However, when a controlling shareholder stands on both sides of the transaction, the business judgment rule cannot apply. Instead the standard of 'entire fairness' will apply.[178]

b) Defensive Repurchases

Given the fact that the allegations of the plaintiffs in *Grobow* were not sufficient, it is questionable who bears the burden of proof concerning whether or not directors acted

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[172] *See* Aronson v. Lewis, 473 A.2d 805 (Del. 1894). The business judgment rule 'is a presumption that in making a business decision the director of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interest of the company."
[173] Grobow v. Perot, 539 A.2d 180, 187-91 (Del. 1988).
[174] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-5 (Del. 1985).
[175] So called primary purpose test. *See* Petty v. Pentech papers, Inc., 347 A.2d 140 (Del. Ch. 1975); Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977).
[176] 539 A.2d 180 (Del. 1988).
[177] 539 A.2d 180, at 190 (Del. 1988).
[178] Kahn v. Lynch Communication Sys., 638 A.2d 1110, at 1116 (Del. 1994); Kahn v. Tremont Cor., 694 A.2d, 422, at 434 (Del. 1997).

solely to entrench themselves in office. In *Bennet v. Propp*[179], the burden was placed on the defendant to justify the repurchase as primarily in the corporate interest. The chief executive officer acquired over 25 per cent of the corporation's stock, after he got to know that one shareholder planned to buy 50 per cent of the publicly held shares. The court stated that in a hostile takeover climate there is always a conflict of interest.[180]

In *Cheff v. Mathes*[181], the board of Holland Furnace Company repurchased about 17.5 per cent of its stock held by a single shareholder: Maremont. Maremont wanted to change the distribution methods of Holland Furnace. In addition to that, the board of Holland Furnace believed that his interest in the well-being of the corporation was doubtful. The court found that two of the directors had self-interest in the deal, because they either received a substantial salary or sizable fees. In the case of the other directors a similar self-interest could not be found. The court held that where a majority of the directors are not dealing because of self-interest, the business judgment rule prevails so long as they are showing "reasonable grounds to believe a danger to corporate policy and effectiveness existed by the presence of the Maremont stock ownership."[182] The directors can meet this burden by showing good faith and reasonable investigation. The threat to the corporation does not need to go so far that there is an imminent possibility of someone who wants to raid or loot the corporation. The subjective test, whether the board acted in good faith and conducted reasonable investigation, is constructed on objective premises. The court inquires, whether the majority of the directors are outside directors, whether there is a threat, and what the nature of the threat is. There is a threat to the shareholders when the tender offer is coercive[183], offers an inadequate price[184] or is made by a known raider[185]. The threat can be an outside or an inside threat, either to gain control or to change corporate policies. Another important point is the development of the decision, who was consulted and how much time the decision took.[186]

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[179] 187 A.2d 405 (Del. 1962).
[180] Bennett v. Propp, 187 A.2d 405, at 409 (Del. 1962).
[181] 199 A.2d 548 (Del. 1964).
[182] Cheff v. Mathes, 199 A.2d 548, at 555 (Del. 1964).
[183] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, at 953 (Del. 1985).
[184] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, at 181 (Del. 1986).
[185] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, at 956 (Del. 1985).
[186] *Compare* BLACK , *supra* note 66, at § 6.03 [3][b], 6-32-6-33.

The most famous and standard-setting decision, to the present day, *is Unocal Corp. v. Mesa Petroleum Co.*[187] In 1985, Mesa Petroleum attempted to obtain control of the Unocal Corporation. In response to the bid of Mesa Petroleum, the board of directors made a self-tender offer which excluded the shares already held by Mesa Petroleum. This condition to the self-tender offer was subjected to litigation. The Delaware Sperior court held: "because of the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."[188] In response, the court developed a uniform standard to scrutinise defensive tactics adopted by a board of directors to thwart a hostile takeover. The court applied a two-step approach which has to be met before the actions of the directors are protected by the business judgment rule. The first step is the standard already developed in *Cheff v. Mathes.* The directors must act in good faith and with reasonable investigation when they take action to defend against a takeover threat or a dissident shareholder who wants to change the corporate policy.[189] The second step entails a comparison between the defensive measurement and the takeover threat. The defensive tactic must be "reasonable in relation to the threat posed."[190] This so called proportionality test[191] entails the detailed examination of the impact which a takeover bid might have on shareholders and other stakeholder like creditors, as well as an examination of the type of takeover bid and the defensive tactic applied. [192] The greater the threat, the more effective the reactive measure can be. In the concrete case, the court held that the action taken by the board of directors was appropriate because of the coercive nature of Mesa Petroleum's tender offer.[193]

In 1986 the Delaware Chancery[194] court gave the directors a possibility to escape through the backdoor. If they could not meet the requirements of the Unocal test, then they were given the chance to establish that the transaction was objectively or intrinsi-

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[187] 493 A.2d 946 (Del. 1985).

[188] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, at 954 (Del. 1985).

[189] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, at 955 (Del. 1985).

[190] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, at 955 (Del. 1985).

[191] *See* City Capital Assocs. Ltd. Partnership v. Interco Inc., 551 A.2d 787, at 796 (Del. Ch. 1988).

[192] *Compare in more detail*: Bielawski, *Note, Selective Stock Repurchases after Grobow: The Validity of Greenmail under Delaware and Federal Securities Laws,* 15 DELAWARE JOURNAL OF CORPORATE LAW 95, at 101 (1990); Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities: An Update*, 40 BUSINESS LAWYER 1403 (1985).

[193] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, at 956 (Del. 1985).

[194] AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, at 115 (Del. Ch. 1986). And in 1989 Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257 (Del. Ch. 1989).

cally fair. In *Polk v. Good*[195] the court did not apply the Unocal standard. After founding that the good faith and reasonable investigation test was met because 10 out of 13 directors were outside directors and investment bankers and legal councils gave advice, no further investigation was made. This court simply said the evidence was sufficient to constitute prima facie evidence showing good faith and reasonable investigation. Texaco bought its stock held by the Bass Brothers at a substantial premium. Because the repurchase actually loaded the corporation with debt, and the threat was not imminent or at least questionable, the second step of the Unocal standard is likely to have failed.[196]

Another standard applies when defensive measures are undertaken during a period when the company is for sale. The directors have to play the role of auctioneers, and are responsible for getting the best deal for the shareholders.[197] In the case of defensive stock repurchases, there would be no reason to allow management to buy a corporation's own stock when their role is changed to auctioneers. The prohibition does not apply in case own stock is needed for the fulfilment of the takeover.

In *American General Corp. v. Unitrin, Inc.*[198], the Delaware Chancery court ordered that the defendant was enjoined from repurchasing own stock. Unitrin planned to purchase 10 million of its outstanding shares in response to a merger offer by American General. An insider group, basically formed of directors of Unitrin, controlled about 23 per cent of Unitrin's outstanding stock. The repurchase program would lead to an increase of the insider group's holding from 23 per cent to 28 per cent. The company's articles provided that any business combination would require a supermajority vote of not less than 75 per cent of the outstanding shares. The insider group's holding of 28 per cent would therefore result in their ability to veto such decisions. The Court of Chancery stated: "I conclude that because the only threat to the corporation is the inadequacy of an opening bid made directly to the board, and the board has already taken actions that will protect the stockholders from mistakenly falling for a low ball negotiating strategy, a repurchase program that intentionally provides members of the board with a veto of any merger proposal is not reasonably related to the threat posed by American General's negotiable all shares, all cash offer. The Delaware Superior Court reversed the decision because it found that the repurchase program was not unnecessary. "The Unitrin board had the power and the duty, upon reason-

[195] 507 A.2d 531 (Del. 1986).
[196] *Compare* BLACK, *supra* note 66, at § 6.03 [3][c], 6-36.
[197] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).
[198] Fed. Sec. L. Rep. (CCH).

able investigation, to protect Unitrin's shareholders from what it perceived to be the threat from American General's inadequate all-cash for all-shares offer. The adoption of the poison pill and the limited repurchase program was not coercive and the repurchase program may not be preclusive. Although each made a takeover more difficult, individually and collectively, if they were not coercive or preclusive the Court of Chancery must determine whether they were within the range of reasonable defensive measures available to the board...The Unitrin Board's adoption of the repurchase program and the poison pill is entitled to review under the traditional business judgment rule."[199]

If the defensive measure is approved by the shareholders, directors are more likely to pass the Unocal test. Shareholders can approve a defensive measure by either voting for it[200], or in tendering their shares in a non-coercive self-tender.

c) Conclusion

In conclusion, one can say that there is only one case where stock repurchases are not allowed. That is when the board of directors acted solely to save their jobs. But this only applies when there is at least an imminent threat of a takeover bid or a shareholder who wants to change the corporate policy. That leaves space for management to manoeuvre before such threats become obvious. Preventive defensive measures can be undertaken almost without restrictions. The restrictions, as known from European laws, are not even considered. A corporation can trade with its own stock or can acquire as many shares as it likes. No authorisation by the shareholders is needed.

4. New York Law

As in Delaware, New York also allows repurchases out of any surplus.[201] Exceptions to that rule are the same as in the Model Business Corporation Act. New York courts also apply the business judgment rule, but with a slight shift in the burden of proof. The business judgment rule does not protect an uninformed decision. Directors have

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199 Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995).
200 E.g., Kaplan v. Goldsamt, 380 A.2d 556, at 569 (Del. Ch. 1977); Martin v. American Potash & Chem. Corp., 92 A.2d 295, at 297 (Del 1952).
201 New York Business Corporation Law § 513 (c) (Mc Kinney 1986).

to exercise reasonable diligence in coming to a decision.[202] If the plaintiff acts out of self-interest or bad faith, the burden of proof shifts entirely to the directors "to prove that the transaction was fair and reasonable to the corporation."[203] New York law is especially interesting because in 1985 the legislature restricted greenmailing. § 513 (e) of the Business Corporation Law provides that a corporation cannot purchase or agree to purchase more than 10 per cent of its stock from a shareholder for more than its market value, unless the purchase or agreement to purchase is approved first by the board of directors and then by the holders of a majority of all outstanding voting shares. The restriction does not apply in case shares are bought from all shareholders or if the shares have been beneficially owned for more than two years.

5. Federal Law

The federal law's foremost concern is the regulation of tender offers in general. Congress enacted the Williams Act in 1968 as an amendment to the already existing Securities Exchange Act of 1934.

a) Open Market Repurchases

Open market repurchases are only subject to the regulation provided by the Securities and Exchange Commission (SEC) during the course of an interfirm tender offer. This regulation is only concerned with disclosure requirements. More specifically, section 13 (e)(1) of the SEC Rules prohibits a target from repurchasing shares during the course of a tender offer unless it has filed information with the SEC, and has transmitted to its equity securities holders the substance of that information within the past six months. The SEC can demand whatever information it deems necessary. Usually that embraces the reason for the purchase, the source of the funds, the number and price of the shares to be purchased, and the method of purchase.

b) Self-Tender Offers

Section 14 (d) of the Williams Act made a distinction between self-tender offers and tender offers in general. However in 1979 the SEC regulated issuer stock repur-

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[202] Hanson Trust PLC v. MLSCM Acquisition, Inc., 781 F.2d 264, at 274 (2d Cir. 1986).

[203] Treadway Cos. v. Care Corp., 638 F.2d 357, 383 (2d Cir. 1980).

chases, including self-tenders. Rule 13 (e)(4) and Schedule 13 (E)(4) were adopted and subsequently aligned with section 14 (d) of the Williams Act which already regulated third party tender offers. Rule 13 (e)(4) is concerned with the regulation of tender offers, for their own equity securities, made by issuers or their affiliates, which have a class of equity securities registered pursuant to § 12 of the Act, or which are required to file periodic reports pursuant to § 15 (d) of the Act, or which are registered as closed-end investment companies. Copies of the Issuer Tender Offer Statement on Schedule 13 (E)(4) must be filed with the SEC and shareholders must be provided with certain information.[204] A self-tender offer can be made according to Rule 13 (e)(4)(f). The offer must remain open for at least twenty business days (if not withdrawn) and the issuer must allow shareholders to withdraw tendered shares during the first 15 business days of the offer.[205] The issuer has also to accept any withdrawn tendered security any time after 40 business days from the commencement of the offer, provided the securities have not yet been accepted for payment. If the tender offer is made for less than all the shares of a class, securities have to be accepted on a pro rata basis if more shares are tendered than accepted. However, the issuer has the chance to accept all shares tendered by persons who own no more than 100 shares and who tender them all before prorating shares held by others. This facilitates the removal of splitholdings in order to decrease shareholder servicing costs. An increased offer also benefits the shareholder who tendered before the increase, because the issuer must pay the increased price to all tendering shareholders. These rules contain disclosure requirements as well as substantive regulations, and are therefore more strict and harder to comply with than the requirements for open market repurchases.[206]

In *Santa FE Industries, Inc. v. Green*[207], the issuer announced that the repurchase price was a fair one. The plaintiff reasoned that the price was unfair and the defendant therefore did not comply with Rule 13 (e)(4). The court held that if material facts are disclosed, disclosure of individual motives or subjective beliefs are not required.

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[204] Rule 14 (e)(4)(d) requires dissemination of the basic terms of the tender offer and at least a fair summary of the information called for in items 1 through 8 of Schedule 13 (E)(4).
[205] Or as an alternative if securities have not yet been accepted for payment, during the first 10 business days of a competing offer.
[206] Bradley & Rosenzweig, *supra* note 49, at 1387.
[207] 430 U.S. 462 (1977).

Defendants do not even need to disclose conflicts of interests as long as the facts are disclosed.[208]

C. New Zealand

With the Companies Act of 1993 New Zealand abolished the restrictions proposed in *Trevor v. Whitworth.* After a discussion of the issue from a legal point of view,[209] New Zealand enacted one of the most liberal regulations for a country applying the capital maintenance rule. Different types of share buybacks are classified. The new provisions (sections 58 et seq.) treat share buybacks as a form of distribution to shareholders[210] and are therefore connected with general distribution provisions. This is a similar approach to the problem as in the Revised Model Business Corporation Act.

Section 58 (1) of the Companies Act 1993 permits a company to acquire its own shares in accordance with the procedural provisions, and subject to section 52 of the Companies Act 1993. This section is concerned with distribution to shareholders which is only allowed if the board has previously authorised the distribution, and if the company passes a solvency test. The directors who vote in favour of a distribution must sign a certificate stating that, in their opinion, the company will, immediately after the distribution, satisfy the solvency test and the grounds for that opinion. Distribution already takes place when the company enters into a contract to purchase shares from a shareholder.[211] A prerequisite for any purchase is a provision in the company's constitution expressly permitting share buybacks.[212] Once shares are acquired, the usual procedure is to cancel them immediately on acquisition[213], but the shares can be reissued. The Registrar has to receive notice of any acquisition within 10 working days of the acquisition.[214] However, section 67A of the Companies Act 1993 permits for an exception to the provision. Shares acquired pursuant to section 59 or section 112 of the Companies Act 1993 can be held as treasury stock. The constitution of the company must expressly permit such a possibility and the board has to resolve that the

[208] *Compare* In re PHLCORP Sec. Tender Offer Litig., 700 F. Supp. 1265, at 1269 (S.D.N.Y. 1988).
[209] Dugan, *Repurchase of own shares for New Zealand*, 17 VICTORIA UNIVERSITY OF WELLINGTON LAW REVIEW 179 (1987).
[210] Section 2 (1) Companies Act 1993.
[211] MORISON'S, *Company and Securities Law*, Volume 2, Shares and Shareholders 15.11, G/215 (1998).
[212] Section 59 (1) Companies Act 1993.
[213] Sections 58 (2), 66 Companies Act 1993.
[214] Section 58 (3) Companies Act 1993.

shares concerned shall not be cancelled.[215] Rights or obligations attached to the shares cannot be exercised.[216] In case the shares are sold again they are treated like an issue of shares.[217] In addition the company is only allowed to hold 5 per cent of their own shares of one class at the same time.[218] If the directors fail to comply with the disclosure provisions imposed by the Act they, and the company, run the risk of being held liable for insider trading.[219] Assuming the information the company possesses is likely to materially affect the market price of the company's shares, if this information were publicly available, the company could be held liable.[220] An offer can either be made on a pro rata basis to all shareholders, selectively to some shareholders, or as an on-market purchase with or without prior notice to shareholders.[221]

1. Pro Rata Offer

A pro rata offer must be approved by the board in advance. The decision of the board must be guided by the following factors: The repurchase must be in the best interests of the company; the offer must be fair and reasonable to the company and the board must not be aware of any information that will not be disclosed to shareholders which is material to an assessment of the value of the shares, and as a result of which the terms of the offer, and consideration for the shares, are unfair to shareholders accepting the offer.[222] The first requirement is usually complied with when the company has excess funds which cannot be reinvested in an efficient way.[223] The directors are required to sign a certificate concerning the resolution.[224] If circumstances change after the passing of the resolution, but before the making of the offer, directors are prohibited from acquiring shares.[225] In the case where shareholders decline the pro rata offer, or accept only in part, additional shares from other share-

[215] Sections 67A (1) (a)(b) Companies Act 1993.
[216] Section 67 B (1) Companies Act 1993.
[217] Section 67C Companies Act 1993 and 7.3.9. of the New Zealand Stock Exchange Listing Rules.
[218] Section 67A (1)(c) Companies Act 1993
[219] McKenzie, *Share buy-backs and the disclosure requirements of the Companies and Securities Acts*, NEW ZEALAND LAW JOURNAL 455, at 459 (1994).
[220] CML v. Wilson Neill Limited [1994] 2 New Zealand Law Review 152, at 161.
[221] *See* sections 59 (2), 60, 61, 63 and 65 of the Companies Act 1993.
[222] Section 60 (3) Companies Act 1993.
[223] MORISON'S, *supra* note 211, at 15.10, G/209.
[224] Section 60 (5) Companies Act 1993.
[225] This can also be stated for the other offering types.

holders can be taken up rateably among those shareholders who make their shares available.[226]

2. Selective Offers

Selective offers are permitted when either all shareholders have consented in writing or the constitution allows a selective offer.[227] A written agreement by all shareholders by virtue of section 60 (1)(b)(I) of the Companies Act 1993 still requires the resolution by the board in terms of section 60 (3) of the Companies Act 1993. On the other hand, section 107 (1) of the Companies Act 1993 provides for a different solution with the same requirements (written agreement by all entitled persons). A repurchase made under section 107 of the Companies Act does not require the board's resolution in advance.

The procedure laid out in section 61 of the Companies Act 1993 applies to offers under the ruling constitution. It is concerned with the equal treatment of shareholders and requires a board resolution that the buyback is of benefit to the remaining shareholders. In particular, the terms of the offer, and the consideration offered for the shares, must be fair and reasonable to the remaining shareholders. "Of benefit to the remaining shareholders" should be more far-reaching than "in the best interest of the company". Directors have to demonstrate that they reasonably believed that there would be an advantage to shareholders and not hide behind the business judgment rule.[228] On the other hand, it is unlikely that the courts would require an increase in net shareholder wealth.[229] This would mean greenmailing is only permitted if it would subsequently lead to an auction of the company to a higher bidder. More likely is that New Zealand courts will merge the two requirements and state that a decision which is made in the best interest of the company ultimately leads to a benefit for the remaining shareholders. If this were not the case, there would be little room for applying the provisions for selective offers. In addition the board members who voted in favour of the resolution must sign a certificate regarding the resolution.[230] A selective offer can

[226] Section 60 (2) Companies Act 1993.
[227] Section 60 (1)(b) Companies Act 1993.
[228] *See* Gardner, *supra* note 69, at 170.
[229] *So* Gardner, *supra* note 69 , at 171.
[230] Section 61 (3) Companies Act 1993. MORRISON'S, *supra* note 211, at 15.16, G/217 states that this additional requirement was implemented because of the concern that the selective offer involves board members in an unfair manner to the remaining company. A signed certificate obviously improves the possibility for remaining shareholders to prove a breach of fiduciary duty and other reasons for liability of the involved board members.

only be made after a disclosure document has been sent to each shareholder within a period of between 10 days and 12 months after the posting of the documents.[231] An interesting provision is section 61 (8) of the Companies Act 1993. A shareholder, or the company itself, can apply to the court on the grounds of unfairness. The court reviews all the circumstances of the offer and finally assesses whether or not the criteria are met.[232] That is fundamentally different to the system in the United States, where the board's decision is protected by the business judgment rule. An unfair price would not lead to a restraining of a proposed selective acquisition.

3. On-Market Purchase with prior notice to Shareholders

The board may make offers to all shareholders to acquire a specified number of shares. A resolution, subject to the same prerequisites laid down for pro rata offers is necessary.[233] Before an offer is made, the company must send to each shareholder a disclosure document containing information according to section 64 of the Companies Act 1993. It must set out the maximum number of shares that the board has resolved to acquire; the nature and terms of the offer; any interests of directors in the acquisition; the text of the resolution plus additional explanatory notes, but not the consideration proposed by the board. MORISON'S view makes one wonder about the latter. Since the relevant terms of the offer have to be disclosed, it is somewhat curious what these terms could possibly be on a stock exchange transaction, other than the price. Moreover the resolution has to contain at least a price range to satisfy the requirement of a transaction in the best interest of the company.[234] For listed companies, the New Zealand Stock Exchange Listing Rules require prior notice to the stock Exchange for every proposed acquisition[235] and, opposite to section 64 (2) of the Companies Act 1993, the notice has to specify the maximum price. As in the case of selective offers, a shareholder or the company can file an application to restrain on-market purchases.[236]

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[231] Sections 61 (5)(6) Companies Act 1993.
[232] *Compare* MORISON'S, *supra* note 211, at 15.18, G/219.
[233] Section 63 (1) Companies Act 1993.
[234] See MORISON'S, *supra* note 211, at 15.20, G/220.
[235] Rule 7.6.1-7.6.2.
[236] Section 63 (8) Companies Act 1993.

4. On-Market Purchases without prior Notice to Shareholders

On-market purchases without notice to the shareholders are subject to the same resolution as on-market purchases with notice. However, the number of shares acquired, together with any other shares acquired in accordance with that section in the preceding 12 months, must not exceed 5 per cent of the shares in the same class at the commencement of that period.[237] Disclosure requirements are set out in section 65 (2) and for listed companies also in the New Zealand Stock Exchange Rules.[238] Notice has to be given to the stock exchange within 10 working days, and to the shareholders within three months after the acquisition.

5. New Zealand Stock Exchange Listing Rules

The Listing Rules provide additional requirements that are imposed on a company which wants to acquire its own shares. Giving notice to the Exchange is already mentioned above. In connection with exercising control, Rule 7.7 is of particular importance. The approval of an ordinary resolution is necessary if any person, or group of associated persons, already having the right to exercise no less than 1 per cent of the company's voting rights, increases his ability to exercise effective control. The terms of the acquisition must be disclosed and the notice approved by the Exchange.[239]

V. Situation in South Africa

The South African Companies Act does not contain any provision regarding the repurchase of shares. The current prohibition is based on common law principles. Once again *Trevor v. Whitworth* is the leading authority followed by South African case law.[240]

But a new law will come into force. The Companies Amendment Bill of March 1999, is already passed by parliament and was signed by the President. From 1 June, 1999 onwards, companies are allowed to buyback their own shares. The situation

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[237] Section 65 (1)(b) Companies Act 1993.

[238] Rules 7.6.1-7.6.2.

[239] Rule 6.2.1.

[240] Wolfe v. Liquidators Smyth and Crawford 1914 CPD 187; Sage Holdings Ltd v. Unisec Group Ltd 1982 1 SA 337 (W) 347-349; Unisec Group Ltd v. Sage Holdings Ltd 1986 3 SA 259 (T) 264-265.

was different to the usual procedure of new enactments in South Africa. After the Standing Advisory Committee on Company Law suggested a new regulation of the issue in 1989[241], nothing really happened. A discussion of the subject, either in law journals or in the public, never took place. The proposal was pushed through parliament and finally became law. Although the procedure is suspicious, it will not do any harm, provided the outcome is satisfactory. Unfortunately the new legislation is not persuasive. This especially the case if read in connection with the Memorandum on the Objects of the Companies Amendment Bill, 1999.

A. The new Regulation[242]

The new sections 83 et seq. are headed "Acquisition by Companies of own Shares". Section 85 is headed "Company may under certain circumstances acquire shares issued by it". Two essential prerequisites have to be fulfilled for any repurchase of shares. Firstly, the company's articles must contain an authorisation clause, and secondly, the repurchase has to be approved by special resolution.[243] The special resolution can be either a general one, which is valid until the next annual general meeting, or a specific approval for a particular acquisition.[244] Section 85 (4) of the Companies Act 1973 is concerned with the solvency test. A company shall not make any payment if there are reasonable grounds for believing that the company is, or would after the payment be, unable to pay its debts as they become due in the ordinary course of business, or the consolidated assets of the company fairly valued would after the payment be less than the consolidated liabilities of the company. A result of the acquisition is decreasing capital[245], due to the fact that acquired shares have to be cancelled and restored to the status of authorised shares.[246] Payment for the acquired shares can be made out of any capital, provided the solvency test is met with one exception. If shares are acquired at a premium over the par value, the premium may be paid out of reserves, including statutory non-distributable re-

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[241] TRIHARDT, ORGAN & CILLIERS, No 10 *Transaction of the Centre for Business Law*, University of the Orange Free State (1989).
[242] The following contains only the basic provision concerning the repurchase of shares. It deals not with the enforceability of contracts for acquisition by the company (section 88) and the payment to shareholders (section 90) because this topic is not mentioned in the examination of the other countries. The new Act also contains the disclosure of beneficial interest in securities and new rules concerning the secretary.
[243] Section 85 (1) Companies Act 1973.
[244] Section 85 (2)(3) Companies Act 1973. Any general approval can be varied or revoked by special resolution by any general meeting of the company at any time.
[245] Section 85 (5)(6) Companies Act 1973.

serves.[247] There is no restriction concerning the amount of shares which can be acquired, as long as, as a result of the acquisition, there would no longer be any shares in issue other than convertible or redeemable shares.[248]

In the event that the directors do not comply with the requirements of the solvency test, they are jointly and severally liable to restore to the company any amount paid and not otherwise recovered by the company, subject to any relief granted by the Court under section 248 of the Companies Act 1973.[249] Section 86 of the Companies Act 1973 gives the opportunity to apply to the court for an order compelling a share-holder or former shareholder to pay to the company any money that was paid to such shareholder contrary to section 85 (4) of the Companies Act 1973. The application can be filed by any liable director, or any creditor who was creditor at the time of the acquisition, or who is creditor by reason of debt which arose before such acquisition, or any shareholder.[250] The creditors and shareholder also have the possibility of applying for an order which compels the company to issue an equivalent number of shares to the shareholder or former shareholder, or which is otherwise capable of solving the problem.[251]

The new section 87 of the Companies Act 1973 concerns the procedure of acquisition of certain shares by a company. A company has to disclose the number and class of shares it wishes to acquire as well as the terms and reasons for the offer. It has to deliver or mail a copy of the offer to each registered shareholder and within 15 days after that lodge a copy of the offering circular with the Registrar.[252] The procedure shall not apply when the shares are acquired by virtue of a special resolution passed in terms of section 85 (3) of the Companies Act 1973. It is not clear what was meant by that exception, since section 85 (3) refers only to the validity of a general offer. It would make more sense if the exception referred to a specific approval for a particular transaction, because the reason and terms of the offer will be disclosed during the general meeting anyway. Another exception applies in the case of listed companies. They have to comply with the rules and listing requirements of the exchange were the transaction is going to take place. Bearing that in mind, the scope of application for section 87 (1) of the Companies Act 1973 is very limited.

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[246] Section 85 (8) Companies Act 1973.
[247] Section 85 (7) Companies Act 1973.
[248] Section 85 (9) Companies Act 1973.
[249] Section 86 (1) Companies Act 1973.
[250] Section 86 (2)(3)(a) Companies Act 1973.
[251] Section 86 (3)(b)(c) Companies Act 1973.
[252] Section 87 (1) (a)(b) Companies Act 1973.

Another problem is because of the accelerated legislation procedures, none of the listing rules provide sufficient regulation for disclosure requirement for the repurchase of shares. It will take some time until the rules are adjusted to the new situation. Section 87 (6) of the Companies Act 1973 provides the stock exchanges with the power to determine further requirements. The registrar has to be notified within 30 days of the acquisition.[253]

Section 87 (4) of the Companies Act 1973 requires that shares have to be acquired on a pro rata basis, in case the shareholders propose to dispose of a greater number of shares than the company has offered to acquire. This is, again, subject to the important exception that the transaction is effected on a stock exchange in the Republic.

Under section 89 of the Companies Act 1973, a subsidiary company may acquire shares in their holding company to a maximum of 10 per cent.

B. The Rationale for the Changes

As mentioned before, the reasoning for the changes is dubious. One reason is the flexibility which is given to the financial managers of the company. The centrepiece of the argument is the 'global market' argument. On first sight, this sounds very much like well-known reasons, already used by other countries. Especially for a developing country it seems logical to provide a framework of legislation concerning companies which comply with international standards. This may act either as an incentive for foreign investors, or a prevention measure, so that companies might choose a different place of business. The reasoning in the memorandum goes in a somehow different direction. Global markets are supposed to create a potential danger for the South African markets. A scenario is described which depicts foreign investors, with 'unlimited resources' and unscrupulous behaviour, as responsible for the current crisis on the stock markets. The repurchase of shares could prevent this effectively. This would lead to rising market prices and ultimately result in a market price being unaffected by foreign transactions. One can only wonder how a country, which stuck so long to the principles of *Trevor v. Whitworth,* can not consider the risks already highlighted in that decision. One of the dangers is certainly trafficking or price manipulation. The memorandum declares price manipulation as actually desirable and

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[253] Section 87 (5) Companies Act 1973.

advantageous to shareholders. In the following argument the memorandum goes one step further. It describes, again, the danger that foreign investors bring to the country. As a result of declining market prices, South African companies are potential candidates for takeovers by foreign bidders. These foreign investors are described as asset strippers, and are supposed to act irregularly. In addition to this strange argument for a country which is seeking for foreign investment, there is also a faux pas in legal terms. The memorandum illustrates that potential targets could use the repurchase of shares as an effective defensive tactic. In contrast to that statement, any frustrating actions during an offer or an imminent offer are prohibited, except when approved by the shareholders in a general meeting.[254]

The memorandum states that legislation in most of the EEC and USA and other developed markets permits the repurchase of a company's issued share capital, subject to solvency and liquidity criteria. That is simply not true. Even in the United States most state laws have a surplus test rather than a solvency test. Only the revised Model Business Law and California provide for the solvency test. New Zealand also decided in favour of a solvency test, but the whole regulation is subject to more restrictions. When the memorandum refers to the EEC, not a single country can be found which applies the solvency test (due the second European Directive). Even Great Britain, usually a model for the regulations in South Africa, allows purchases only out of distributable profits (public companies).

The memorandum picks up the dangers of buybacks, but forgets to mention the creditors which are most likely to suffer from abuses.

C. Conclusion

The South African legislation is clearly influenced by the regulation of New Zealand. The centrepiece is the solvency test. But unlike New Zealand or the regulation in Great Britain, South Africa does not address the different methods of repurchasing own shares. This creates certain problems like whether or not greenmailing is permitted. There is also no distinction between public and private companies like in Great Britain. A discussion of any legislation has to be measured against the risks inherent in repurchases of shares. In evaluating the new South African legislation, the risks creditors are exposed to are of vital importance.

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[254] General Rule 7 and Rule 19 of the Securities Regulation Code on Takeovers and Mergers.

1. Creditor Protection

As already discussed under III., the capital reduction accompanying buybacks are especially dangerous to creditors. Two different approaches to this have evolved. Most states implemented the capital maintenance rule as a form of compensation for the potentially dangerous concept of limited liability. In contrast, the United States do not know such a strict rule. Protection of creditors is not the main concern of their various Companies Acts. Both concepts have their advantages and disadvantages. If the protection of creditors by law is very poor, creditors have to protect themselves, and will monitor their investments very closely, which can lead to difficulties for enterprises which require necessary funds. On the other hand, that system might encourage enterprises to ensure there projects are feasible, in order to convince creditors that the project is worth investing in. The principle of capital maintenance is a safeguard for creditors which resulted in a different attitude to providing their money. In theory firms are not that closely monitored since there is always a guaranteed capital for creditors. These different perceptions created different national economies.

The problem which can arise lies in the radical change of the legislation, without having a necessary transitional phase for the state economy. What South Africa did is to abolish its firm principle of capital maintenance, and replace it with a regulation little concerned with the protection of creditors. Once one has decided that repurchases of shares should be allowed, one has to go on and look at the protection of concerned groups. When it comes to creditor protection, two key factors can ensure a certain level of protection. The most important one is the source of the funds used. Great Britain allows for repurchases out of distributable profits, or a fresh issue of shares (public companies). In this case that there would be no reduction of capital.[255] The second European Directive formulates that repurchases can be made as long as they not reduce the net assets below the amount of the subscribed capital, plus those reserves which may not be distributed. The Model Business Law as well as the Delaware law apply a surplus test. The possibility chosen by South Africa is in fact the "most far-reaching available on the global market". New Zealand, Australia,

[255] Although some authors state that even that restriction can not be tolerated because "every dollar paid out to shareholders in repurchases is one less doallr available to satisfy the company's debts in the event of a winding-up. McCabe, supra note 47, at 118; Kessler, *Share repurchases under Modern Company Laws*, 28 FORDHAM LAW REVIEW 637, at 652 et seq. (1959-60).

Canada, California and the Revised Model Business Law are applying some form of solvency test.

This has to be seen together with the second safeguard possibility. Legislation could restrict the amount of shares repurchased for a certain time period. This is the rule in the European Union, and it effectively restricts possible abuses. The danger of the South African approach lies in the everlasting possibility of buying back shares until there is only one left. The funds guaranteed for creditors under the old capital maintenance rule have diminished to virtually zero. The creditors are exposed to the whim of the remaining shareholder. It is not only that the former guaranteed capital is diminished but also that there is a higher risk of insolvency during the usual course of business when companies are debt financed.[256] The solvency test cannot helpfully restrict possible abuses. First there is the uncertainty of the test itself. When is the company insolvent, what is a fair value of the assets? Secondly there is the economic perspective. A firm on the verge of insolvency should not be able to distribute money to its shareholders. If this does not render the company insolvent in the short-term, such behaviour can contribute to an insolvent firm in the long-term. The safeguard of the new section 86 of the Companies Act 1973, that directors are liable and shareholders have to pay back any consideration received due to a previous breach of the solvency test, is not satisfactory. This is a case of trying to save the situation when everything is already lost. Such a situation calls for preventive measures. It is a lengthy and costly procedure to pursue shareholders and liable directors. In addition, this section is not able to prevent the creditors from perpetrating long-term strategy abuses.

The criticism is especially valid for a country which was at the forefront of the capital maintenance rule. A change from one extreme to the other, without bringing the additional codes and rules in line with the new regulations, will cause more trouble than relief to financial managers. On the other hand, one has to admit that the capital maintenance rule is questionable in itself. South Africa did not require a thin capitalisation rule or a minimum capital base. Furthermore, creditors usually do not rely on the share capital of the company but on the future prospects. Investments are secured with various methods. One should certainly never forget the power of the creditors. If there is a constant disagreement on the distribution policies of the board, future creditors are not likely to be assessed. That touches on an argument concerning the whole market place. The "self regulating powers" of the market would

hardly allow any company to distribute to shareholders, when they should not do so. Companies are dependant on the creditors, which sometimes leads to a situation where the creditors rather than the board or the shareholders determine the course of the company. It is difficult to weigh the possible disadvantages of too much creditor power and too much shareholder power. It seems that South Africa is clearly going the way of a shareholder value orientated legislation. The motivation for the legislation was to fight the abuses by foreign investors. What will they do when in 10 years time most of the mayor companies in South Africa are de facto controlled by large institutional investors from the USA or Europe. This is not necessarily a result of hostile takeovers by foreign companies but just a matter of fact that, provided South Africas economy is stable, foreign institutional investors will continue to invest in South Africa.

2. Shareholder Protection

The other group which is prone to abuses is the shareholders, especially the minority shareholders. The risks can be effectively minimised when the authority to repurchase shares is at the discretion of the general meeting, and repurchases are only allowed when expressly permitted in the company's articles. South Africa requires a special resolution no matter whether it is a public, private or closely held company, and also provides for a clause in the company's articles. This is particularly helpful for minority shareholders. Possible abuses like management entrenchment or non-equal treatment of shareholders are reduced. By providing that acquired shares have to be cancelled, South Africa chose the same direction of equal treatment and preventing management entrenchment. The wording of the new regulation does not distinguish between selective offers, or off-market offers, and offers to all shareholders. But when complying with the prescribed procedure, selective offers seem to be permitted. The immanent danger of selective offers, that some shareholders can be better off than others, is best averted with the requirement of a special resolution. The famous American greenmail cases are not likely to happen in South Africa, because there is no room for the management to proceed without shareholder approval.

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[256] *See* III A 18.

3. Disclosure Requirements

Disclosure requirements are a powerful tool to ensure fair actions. The new sections contain virtually no disclosure requirements. It is up to the stock exchanges and possibly the Takeover Code, to supplement the existing regulations. Only if the shareholders are informed about the circumstances, they can make a reasoned decision. New Zealand could act as a model with its comprehensive disclosure provisions. One should pay attention to the source of funds used for the repurchase, the exact terms of the offer, and any possible director's interests. Disclosure is also of great importance to the creditors. Once furnished with information, they can "approve" or dismiss the policies of the board. Future investments can be dependent upon distribution policies of the directors.