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Notes and Comments

Regulation of Takeover Defenses: A Comparative Study of Buyback of Shares as a Takeover Defense

Sakshi Gupta*

Though the conclusion of the Arcelor-Mittal deal turned out to be an amicable one, it did lead to an increased focus on the question of the options available to a company to avert an undesirable takeover bid, and the legitimacy of doing so. Of late, there have been a spate of takeovers, and there has been much debate on the legitimacy of takeover defenses. This paper attempts to study one measure that is available to the target company: buyback as a takeover defense. The attempt will be to study the area with reference to the difference in the approach across three countries: India, UK and the USA. The first section will give a brief introduction to the problem. The second section will examine the permissibility of buyback as a defense to a proposed takeover and the rules to be complied with in doing so. The third section will look at the effectiveness of buyback as a takeover defense, and the fourth will examine the desirability of employing the technique with reference to its impact on shareholder value. In the fifth and final section the author will give a brief overview of the law in this area and examine whether buyback of shares should be a preferred defense to takeovers, both in terms of efficiency and desirability.

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I. INTRODUCTION

The management and the existing shareholders of a company may often find it necessary to thwart a hostile takeover bid. There may be several reasons for necessitating such a move: to get a better price for the shares, or because of the honest belief that the offeror will harm the corporation, or merely as a safeguard against the loss of authority by the management. Whatever may be the motivation, alongside the growth in the number of takeovers a veritable arsenal of defenses that may be employed to defeat the bidder has developed.[1]

There is a difference in academic opinion on whether the management should have any power to resist a hostile takeover at all, and whether defenses to takeover inevitably lead to a loss in shareholder value.[2] In the vast amount of legal and economic scholarship that the issue has stimulated, the tendency has often been to characterize takeover defenses as all-good or all-bad.[3] In the support of takeover defenses, it may be said hostile bids can often be disruptive and costly to the

[1] There are several other defenses to a takeover bid, which may be used in combination. For instance, a company may advise the shareholders not to accept the offer for purchase by the acquirer as the proposed takeover would bode ill for the company, sell an important asset thus making the takeover less attractive, or it may encourage a rival bid by a more welcome acquirer etc. See: David S. Bradshaw, *Defensive Tactics Employed by Incumbent Managements in Contesting Tender Offers,* 21(9) STAN. L. REV 1104 (1969).

[2] Easterbrook and Fischel, *The Proper Role of Target's Management in Responding to a Tender Offer,* 94 HARV. L. REV. 1161 (1981) [hereinafter 'Easterbrook and Fischel'] for instance argue that any management interference causes loss of shareholder value.

[3] The extreme positions that have been taken may be illustrated in two seminal articles- One written by Easterbrook and Fischel, *Supra* note 2 where defenses have been generally characterized as undesirable, and the other by Martin Lipton, which

target company, bids may exploit market flaws and pricing inaccuracies, and that a successful hostile takeover may have several socially harmful consequences, such as layoffs.[4] On the other hand, there is a forceful and empirically supported argument that takeovers have certain benefits, in that they generate profits for the company's shareholders, promote the efficient utilization of assets and serve to consolidate the shareholder base.[5] A general acceptance or rejection of all takeover defenses in all cases does not give any practical guidance, as there are definite situations where it may be necessary for a company to defeat a takeover bid (for instance if the bidder's offer is with the intention of asset stripping the target or using the assets of the target to secure the leverage for the takeover). The better view, (which is also reflected in the policy of the three countries being considered in this paper) seems to be that certain takeover defenses must be allowed, but with enough checks to ensure that negative effects are minimized and basic principles of good corporate governance are observed.

While it is necessary for policy makers to allow the retention of the power to defend a takeover bid albeit with controls, it now remains to be seen the relative importance that the two constituent elements of a company: namely the board of directors and the shareholders, must be given in the process of executing a takeover defense.

On the one hand, it is necessary to restrict the power to avert a takeover in the hands of the management. An impending takeover would often mean the displacement of the existing management, and therefore there is an incentive for the management to defeat even a beneficial takeover to extend its own control over a company. As such situations involving a conflict of interest may arise in certain cases, there is definitely a case for regulating the power of the management to defeat a takeover bid.[6]

However, corporate governance today recognizes the interests of constituencies other than the shareholders, namely the employees and the

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argues in favour of maximum scope being given to the operation of defenses to the extent that a defense only be open to scrutiny under the business judgment rule. See: Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 Bus. Law 101 (1979).

[4] John Coates, *Explaining Variations in Takeover Defenses: Failure in the Corporate Law Market*, Discussion Paper No. 297, *available at* <http:/www.harvard.edu/programs/olin_center/> (last visited 30th April, 2007) at 5-6.

[5] *Id.*

[6] Easterbrook and Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. Rev. 277 at 279.

creditors[7], and maximization of shareholder value cannot be the only guide to policy creation. Vesting some power to frustrate an unwelcome bid in the hands of the management is therefore unavoidable in order to afford protection to these constituencies, as the alternative organ, the general meeting comprises of shareholders, who are generally permitted to act in their own interests and are not vested with fiduciary duties.[8] Further, if the shareholders are mainly those who hold shares in the short term, the long term interests of the company may suffer through a takeover if shareholder wealth maximization is the only yardstick adopted.

Law and policy in context of takeover defenses must therefore provide some power in the hands of the management, but at the same time allow shareholders ample control and the opportunity to make an informed decision. The fear of the management acting out of selfish motivations can then be allayed, while retaining the efficiency of the management but putting into place effective checks to ensure good corporate governance. This can be done, first, through the enforcement of fiduciary duties of the management, so that an action to reject a bid motivated by the selfish interests of the management can be set aside by the courts. Second, restrictions must be placed on specific actions by the management, and third, shareholder involvement must be made mandatory through legislation.[9]

II. An Overview of Takeover Defenses

A. Defenses That Can be Used to Defeat a Takeover Bid and the Degree of Regulation

With an increase in the frequency of takeover bids, the arsenal of defenses in the hands of the target has grown in proportion. While the number of innovative defenses that can be adopted is too large to be covered completely, this section will give an overview of some commonly employed defenses, the degree of importance the management has in their execution and the effects on the welfare of the corporation and its shareholders. Another thing to note is that while judicial controls apply equally to all forms of defenses (as these operate mainly to ensure that the management acts in good faith and for the benefit of the company) the degree of controls that the legislature wishes to impose varies with each defense.

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[7] *See*: Gower and Davies, Principles of Modern Company Law 371-379 (2003), [hereinafter 'Gower and Davies'].

[8] North West Transportation Co. v. Beatty, (1887) 12 App. Cas. 589. *See*: Gower and Davies, *supra* note 7, at 486-487.

[9] Steven Rosenblum, *Proxy Reform, Takeovers, and Corporate Control: The Need For a New Orientation*, 17 J. Corp. L. 185, 209-210.

The defense that arguably places the greatest amount on power in the hands of the incumbent management, and is therefore widely viewed with great suspicion is Greenmail. The strategy behind this defense is to repurchase the shares of the company from the bidder company at a negotiated higher price. Greenmail is considered the most dangerous and least preferred form of buyback of shares to thwart a takeover. [10]

The move is criticized firstly as it violates shareholder equality by denying the same price to other shareholders. In addition it may encourage takeover bids solely for the purpose of pressurizing the management to resort to greenmail. In the United States Greenmail is discouraged by the imposition of a 50% excise tax on the recipient company. It may also be prevented by an inclusion of a clause prohibiting the same in the Articles of Association. In England, the principle of shareholder equality must be applied while in India, greenmail is prevented by law. [11]

Selling of a key asset, popularly known as the "Crown Jewel" sale, is another tool in the hands of the management. When the primary motivation of the bidder is to gain control over a certain asset, selling of the asset may thwart the takeover. However, if this is not a key motivation, and the sale is at a favourable price, this scheme may further encourage the bidder to take over the company, as the proceeds can be used by them to finance the bid.[12] Controls on this type of strategy exist mainly in the form of judicial scrutiny of the action of the management as well as specific clauses in Statutes which prohibit this sort of an action.[13]

Another defense strategy is to involve another company which is favourable to the management. There are two variants of this defense. The first is a defensive merger, or the 'White Knight.' The target company may choose a more congenial company to merge with. In the "White Squire" variation of this defense, a block of shares may be sold to a third party, but without causing a transfer of control, and with conditions such as a requirement to vote in compliance with the target's management.[14]

It is evident that this defense does not suffer the problem of excessive management control, as a plan involving transfer of shares cannot succeed without

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[10] J.F.WESTON ET AL., TAKEOVERS, RESTRUCTURING AND CORPORATE GOVERNANCE, 567-568 (2002) [hereinafter 'J.F. WESTON']

[11] *Id.*

[12] FLEISCHER AND SUSSMAN, TAKEOVER DEFENSE, 13-27 (2001).

[13] For instance, regulation 21(d) of the City Code in England prohibits such sales without the sanction of the shareholder. See: WEINBERG AND BLANK, TAKEOVERS AND MERGERS, 4191-4192 (2001).

[14] *Id.*

shareholder consent. However there are some problems with the strategy's efficacy as a defense per se. If the target's management shows itself to be amenable to accepting a takeover bid, it would be difficult to convince shareholders to refuse a better offer from the first unwelcome bidder. Therefore, if the management's actions are prompted in the interests of the company (against a competitor who wants to acquire the company to strip its assets for instance) or its employees, this is not always a practical strategy to adopt.

Yet another set of defenses involve a change in the company's constitution, imposing conditions restricting the transfer of control of the company. For instance, by way of a 'supermajority amendment,' it may be stipulated that any change in the board must be approved by a two thirds or greater majority of the shareholders. Here again, the success of the measure depends on the legal permissibility of such an amendment and shareholder approval.[15]

B. Buyback of Shares as a Specific Takeover Defense:

Buybacks as a defense, which constitutes the focus of this paper, is executed through the repurchase by a company of its own shares, to reduce the number of shares available or to increase the price at which the remaining shares can be bought, or alter the ratio in favour of the promoter group.[16]

Buyback of shares may be employed by the management of a company as a tool to defend against an unwelcome takeover aiming at one of the following consequences: either the buyback will alter the percentage of the shares held by a shareholder group which is unlikely to accept the offer of the potential acquirer, or by raising the price of the shares above the offer price of the bidder, thus making the takeover more cumbersome.

This paper is primarily concerned with the operation of buyback of shares as a particular takeover defense, both from the perspective of pure efficiency in the business sense as well as from its desirability from the policymaker's perspective. This particular defense illustrates both types of possible controls: common law devices in the hands of the courts such as enforcement of fiduciary duties or the business judgment rule, as well as legislative measures.

It must be noted that the repurchase of shares itself is looked at with misgivings in most jurisdictions, given that it militates against the fundamental principle against return of capital, and is only permitted in restricted

[15] J.F.WESTON, *supra* note 10 at 572.

[16] Michael Bradley et al., *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377, 1378-1379 (hereinafter 'Bradley').

circumstances.[17] While opting for a buyback, there are two ways in which restrictions are imposed upon the management of the company. First, the general fiduciary duties that are imposed on the directors, ensure that the takeover is not blocked to perpetuate the directors' own interests. The second form of restriction is through detailed guidelines and restrictions, which vary across jurisdictions. The next section deals with the role of fiduciary duties in circumscribing the powers of the directors.

III. Judicial Controls over Management Actions in Buybacks

It will be seen later that the legal regimes in UK, US as well as in India provide for specific duties that directors must comply with when it comes to using buybacks as a defense to takeovers. However, even without these specific guidelines to action, principles of corporate governance applicable generally to directors to a large measure counter the problem of directors using buybacks to further their own interests in continuing to be at the helm of the company's affairs.

A. Judicial Devices in the United States

In the United States, the directors' decision to avert a bid using any device must satisfy the standard imposed by the 'business judgment rule.' The business judgment rule as formulated by American Courts, simply put means that a Court will not substitute its judgment for that of the directors, as long as the judgment was motivated by a "rational business purpose."[18] The Court attempts to examine whether there has been a breach of fiduciary duty by the directors in repurchasing the shares to thwart a takeover bid where an order is sought against the repurchase programme. While different states are governed by different statutes and precedents, the current standard is adequately summed up in the case of *Unocal Corp.* v. *Mesa Petroleum Co.*,[19] where the Court held that the directors must

[17] For instance, in India § 77 operates as a general prohibition against buyback of shares, though the introduction of § 77 A in 1999 has made it permissible subject to restrictions. The rationale for this general prohibition has been explained in Re: Exchange Banking Co., [1882] 21 Ch D 519 as follows: *"The creditor gives credit to the company on the faith of the implied representation that the capital shall be applied only for the purposes of the business and has therefore the right to say that the corporation shall keep its capital and not return it to shareholders." See also* Strachan, *Return of the Company's Capital to Shareholders*, 26 L.Q.R. 231.

[18] Steven Bradbury, *Corporate Auctions and Directors' Fiduciary Duties: A Third Generation Business Judgment Rule*, 87(1) MICH. L. REV.276.

[19] 493 A.2d 946 (Del. 1985). *See* Gregg Kanter, *Judicial Review of Antitakeover Devices Employed in The Non-Coercive Tender Offer Context: Making sense of the Unocal Test*, 138 U. PA. L. REV. 225.

establish that they did not act solely or primarily out of a desire to perpetuate themselves in office, but were motivated by a good faith concern for the welfare of the corporation and its shareholders.[20]

B. Judicial Devices in United Kingdom and India:

The standard of fiduciary duties expected from directors in UK is regulated by the 'proper purpose test'. Directors are required to act in the interests of the company as a whole and action for the purpose of furthering their own control over the company is a violation of this duty, and the powers conferred on them must be exercised in furtherance of the purpose for which they are conferred.[21] Another aspect of the fiduciary duties imposed on directors is the "no conflict rule." Directors are expected to place themselves in a situation where there is a conflict, or even the potential for a conflict between the interests of the company and the personal interests of the directors.[22] Accordingly, if directors decide to act against a takeover bid solely to extend their control over the company, it will clearly contravene this rule.

In India, the standard is similar to that in England, and again, the directors must establish that their actions were motivated by the benefit of the company as a whole.[23]

Thus the above standards are used by the judiciary to regulate directors' conduct with respect to the affairs of the company. They are essentially *ex post*

[20] The good faith concern of the directors was evident from the facts of this case. Here Mesa had commenced on a hostile takeover bid and had expressed the intention clearly that should the bid be successful, Unocals' shares would be converted to "junk bonds," further the offer was considered by Unocal's management to be grossly inadequate. The offer was made by a minority shareholder, and the management believed that the price offered was inadequate, and the offer of takeover a coercive one. The Delaware Supreme Court therefore upheld a self- tender (buyback) offer by the Unocal Management to defend against the bid. *See also* Unitrin Ltd. v, American General Corp., 651 A. 2d 1361; Norlin Corp. v. Rooney, Pace Inc, 744 F.2d 255 (2d Cir. 1984).

[21] See: Howard Smith Ltd. v. Ampol Petroleum Ltd., [1976] A.C. 821. Here the directors first rejected a takeover bid by one of the existing shareholders, and then went on to make an allotment to a third party, in order to dilute the share of existing majority shareholders, and enable the third party to make a takeover bid. The purpose was to provide the company with capital. The Court, however held that even though the directors acted in what they believed to be the company's best interests, the primary objective of their actions was to alter the shareholding pattern in the company. This constituted an improper exercise of power, as directors were not expected to use their powers to destroy a majority shareholding.

[22] PALMER, PALMERS COMPANY LAW § 8.516 (2001); (hereinafter 'PALMER')

[23] AVTAR SINGH, COMPANY LAW 225 (2005); *See* Shanti Prasad v. Kalinga Tubes Ltd., [1965] 2 S.C.R. 720.

remedies to undo the harm caused by an errant management. The decision to resist a takeover bid, and actions taken in furtherance thereof also have to comply with these requirements, and this acts as a fetter on the capacity of directors to abuse their position for perpetuate their own control.

IV. Permissibility of Buyback as a Takeover Defense: India, the UK and the USA.

As stated earlier, the need for regulation in case of takeover defenses arises to ensure that the management does not succeed in putting off a potential takeover that may be beneficial to the company and its shareholders merely to perpetuate its own control.[24] While to some measure this is accounted for through the imposition of fiduciary duties on directors, specific rules of conduct when the takeover offer is made and when the management decides to resist it are also required. In the area of buybacks, this has to be seen along with the general principles prohibiting buybacks as a defense given the general prohibition against return of capital that buybacks are seen to militate against.[25] The extent of regulation varies in different jurisdictions.

A. Buyback of Shares as a Takeover Defense in India: Legislative Policy and Controls

In India, buybacks have been considered a legitimate shield against a takeover bid, and this use of the technique was in fact one of the reasons why

[24] *See* MM Brown et al., Takeovers: A Strategic Guide, and Mergers and Acquisitions, 9-38 (2001) (hereinafter 'Brown'). the section discusses the prospect of management abuse. See also John Coffee, *Regulating the Market for Corporate Control,* 84 Colum. L. Rev. 1145 (hereinafter 'John Coffee') where the author discusses a significant volume of literature discussing the management's motivations in defending against takeovers. Professors Easterbrook and Fischel in particular favor management passivity to takeovers. The author of the above article however is opposed to a monolithic view of takeovers, and says that it is dangerous to characterize takeovers either as beneficial or harmful, they may be both, and believes that in general, takeover defenses that operate with shareholder control, such as buyback for instance, are far less dangerous to the interest of the shareholder than those where the management can bypass the shareholder *in toto* for instance in lockups or the "crown jewel defense" which comprises the sale of a prized asset.

[25] For instance, in India § 77 operates as a general prohibition against buyback of shares, though the introduction of § 77 A in 1999 has made it permissible subject to restrictions. The rationale for this general prohibition has been explained in Re: Exchange Banking Co., [1882] 21 Ch D 519 as follows: *"The creditor gives credit to the company on the faith of the implied representation that the capital shall be applied only for the purposes of the business and has therefore the right to say that the corporation shall keep its capital and not return it to shareholders."* *See* Strachan, *supra* note 17.

section 77A, which permitted buyback of shares by a company for the first time, was introduced in the Companies Act in 1999.[26] To understand the legal regime governing buybacks in India and their operation in context of takeovers, there are three instruments that must be studied: section 77 A of the Companies Act, the SEBI Takeover Code[27] and the SEBI Buyback Regulations.[28]

While Indian law has no express provisions regulating buybacks in the specific context of takeovers, the effect of the three instruments in combination does serve to operate as a check. A company may purchase its own shares from the existing shareholders proportionately.[29] The buyback must be authorized by the articles[30] and cannot exceed 25% of the total paid up capital and free reserves, as well as 25% of the total paid up equity capital in that year.[31] This prima facie places a restriction on the quantum of shares that may be repurchased. However, this would in most cases suffice to thwart the bid as in any case, a purchase of 25% of the shares would greatly increase the value of the remaining shares and also alter the proportion of shareholding significantly. The most potent protection against abuse of management powers to thwart a potentially beneficial takeover offer perhaps is by ensuring that a disclosure of the purpose for the buyback is made to the shareholders and the same is done with their consent. Section 77A addresses this concern by first, providing for a special resolution at a general meeting[32] and second, by mandating that the resolution for the proposed meeting must contain a complete disclosure of the material facts as well as the necessity

[26] A recommendation of the working group on the Companies Act, which is regarded as the basis for the amendment, listed the prevention of unwelcome takeover bids as one of the reasons favouring the introduction of a law permitting a company to purchase its own shares. *See* K.K. CHANDRATRE, BHARAT'S CORPORATE RESTRUCTURING, 996 (2001). This shows that the policy of the government per se is not against the employment of buybacks as a takeover defense.

[27] SEBI (SUBSTANTIAL ACQUISITION OF SHARES AND TAKEOVERS) REGULATIONS, 1997; [hereinafter 'Takeover Code'].

[28] SEBI (BUYBACK OF SECURITIES) REGULATIONS, 1998; [hereinafter 'Buyback Regulations'].

[29] This is known in the United States as a tender offer. It must be noted however, that the regulations that operate in that country to buybacks are different in cases of tender offers and open market purchases. *See* Bradley *supra* note 16 at 1379-1381.

[30] § 77A (5): *The buyback under sub-section (1) may be-*

(a) From the existing security holders on a proportionate basis.

(b) From the open market.

[31] § 77 A (2) (a): (*No company shall purchase its own shares or other specified securities under sub-section (1) unless:*) *The buyback is authorized by its articles.*

[32] § 77 A (2) (b): (*No company shall purchase its own shares or other specified securities under sub-section (1) unless:*) *a special resolution has been passed in general meeting of the Company authorizing the buyback.*

for the buyback [33], thus making covert schemes on the part of the management to avoid a takeover difficult. However, it must be noted that a buyback can proceed without requiring the assent of the shareholder where the buyback is up to 10% of the paid up equity capital and free reserves,[34] so depending on how many shares are already held by a group opposed to the takeover, it seems that the management can potentially use buyback to avert a takeover bid without taking shareholder consent. However by virtue of the operation of the Buyback Regulations[35], even where shareholder consent is dispensed with at the first stage, the public notice of the buyback must contain the same disclosures as a notice for the special resolution, at the time of the purchase a shareholder will be appraised of the motivation behind the buyback.

Another noticeable impact of the Buyback Regulations is that in effect the defense of greenmail, which is considered potentially harmful to shareholder interests is prohibited completely, though there is no express mention of this.[36]

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[33] § 77 A (3) *The notice of the meeting at which special resolution is proposed to be passed shall be accompanied by a explanatory statement stating*

(a) a full and complete disclosure of all material facts,

(b) the necessity for the buyback.

[34] § 77 A (2) [provided that *nothing contained in this clause shall apply in a case where*]

(A) The buyback is or less than ten percent of the total paid up equity capital and free reserves of the company and

(B) Such buyback has been authorized by the Board by means of a resolution at its meeting.

[35] A Board Resolution- *(1) A company authorized by a resolution passed by the Board of Directors at its meeting, to buyback its shares or other specified securities under first proviso to clause (b) of sub-section (2) of section 77A of the Companies Act, 1956 as inserted by the Companies Amendment Ordinance 2001 may buyback its shares or other specified securities subject to the following conditions* (c) The public notice shall contain the disclosures specified in Schedule 1. Schedule 1 contains the contents of the explanatory statement to be given with the notice for the special meeting, and includes a disclosure as to the necessity of the buyback. Therefore at the time of the purchase, the shareholder from whom the shares are being sought will be in a position to decide whether the scheme of buyback to defend against the takeover is desirable and should be supported.

[36] A Company may buyback its own shares or specified securities :

"A company shall not buy back its shares or other specified securities through negotiated deals, whether on the stock exchange or through spot transactions or through any private arrangements."

It follows therefore than a company cannot enter into a private arrangement with the potential acquirer to repurchase its own shares at a negotiated premium price. This is known as the defense of greenmail and is considered harmful to shareholder interest. While on the one hand this provision prevents covert manipulation by the management, on the other hand it prevents takeover bids by "corporate raiders"

In fact, the Takeover Code, while prohibiting the sale of company assets after the takeover offer, and permitting communication of the Boards' opinion on the offer to the shareholders (and thus addressing itself to other aspects of takeover defenses), does not deal with buyback as a specific defense at all.[37]

B. Buyback of Shares as a Takeover Defense in the United Kingdom

The general policy in England on takeover defenses is to circumscribe to a great extent the powers of the Board to thwart a takeover, and as a consequence, whether or not the bid is successful depends mainly on the shareholder.[38] The regime may be understood with reference to the *City Code on Takeovers and Mergers*. The informed consent of the shareholders is ensured by several provisions such as furnishing competent independent advice regarding the bid to the shareholders. Further, general principles 2 and 3 mandate that once the Board has been informed of an imminent offer, all information must be disclosed to the shareholders and that no action frustrating the offer can be taken by the board without the approval of the shareholders in general meeting.[39] This would cover any instance of buyback as a takeover defense, unlike in India where such consent is not required if the purchase is up to 10% of the paid up capital. Further Rules 21 and 37.3 lists purchase of shares as one of the areas where the approval of shareholders is required.[40] It is evident therefore that in England in keeping with the general policy of discouraging takeover defenses at the hands of the management, buyback also requires the active consent of the shareholders.[41]

C. Buyback of Shares as a Takeover Defense in the United States

The greatest amount of debate on the issue of buybacks as a takeover defense is perhaps available in context of the United States. Repurchase per se is not

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solely for the purpose of forcing the target to repurchase the stock at a high price. J.F.WESTON, *supra* note 10, at 567-569. *See also* Gordon and Kornhauser, *Takeover Defense Tactics: A comment on Two Models*, 96 YALE L.J. 295.

[37] Regulation 23 (1) (a) and 23(4) of the Takeover Code which deal with the obligations of the Board of Directors of the Target Company. Buyback is not dealt with specifically at all. However, regulation 23 (1) (a) and (1) (b) of the code are important restrictions on the powers of the directors during the offer period. Regulation 23 (1) (a) prohibits the sale of, or agreement to sell or dispose of, any asset, which is not in the ordinary course of business without the consent of a majority of the shareholders. Regulation (1) (b) prohibits the issue of any securities with voting rights during this period without the approval of a majority of the shareholders. Therefore, the possibility of the directors using other defenses discussed above which allow shareholders to be bypassed is negated.

[38] GOWER AND DAVIES, *supra* note 7, at 705.

[39] *Supra* note 7, at 716.

[40] *Supra* note 7, at 717.

[41] For a general overview of the law in England regarding buybacks, *see* PALMER, *supra* note 22, at 6.403 and PENNINGTON'S COMPANY LAW, 224-226 (2001).

discouraged as a defense to takeovers.[42] The main law that regulates the area is section 14(e) of The Williams Act of 1968.[43] Apart from strict disclosure requirements on material facts relating to the tender offer,[44] the target company must itself comply with all the regulations applicable to the bidder if it seeks to make a "counter tender offer."[45] It is also mandatory for the management to disclose its own interests in the takeover.[46]

It must be noted however that the legal standard applicable differs according to whether or not the repurchase is through a "self-tender offer" or an open market purchase. In general the regulations of the Securities Exchange Commission under the Williams Act are far more onerous in case of self-tender offers (offer to purchase stock proportionately from the shareholders).[47] The disclosure requirements are stricter, and substantive requirements are stricter, (such as that if the number of shares tendered are greater than what the target company will accept, the company must accept all shares on a pro rata basis.) The only real imposition on open market purchases is that full disclosure should be made to the SEC and shareholders.[48]

From a study of the above jurisdictions, it is evident that the main thrust of the law is on ensuring that managements do not act to the detriment of the shareholders in defending against a hostile takeover bid.[49] The policy in India is to allow such a move subject to disclosure to the shareholders. In England while the policy in general is to discourage takeover defenses by the management, the

[42] There is a significant volume of scholarship in the United States as to whether any form of defense by the management to takeovers, including the technique of stock repurchase, should be permissible at all. *See* Easterbrook and Fischel, *supra* note 6.

[43] Brown, *supra* note 24, at 320.

[44] These have led to a considerable body of litigation. For instance in Scott v. Multi Amp Corp, 386 F. Supp 44 it was held that the omission of any association of the management was material because a shareholder might have considered the withheld information important in deciding how to vote. In other cases however the disclosure has been held not to be material.

[45] *Ibid* at 320

[46] Scott v. Multi Amp Corp *supra* note 44, at 377.

[47] *See* Bradley, *supra* note 16, at 1385-1388. The author discusses the regulations applicable in case of a tender offer and in case of open market purchases, and argues that the SEC should be more liberal in permitting repurchases self tender offers, and also argues against the approach of some academics who seek to bar all forms of takeover defenses at the hands of the management.

[48] Bradley, *supra* note 16, at 1385-1388.

[49] One view for instance is that a hostile takeover should in fact be welcome as it helps to replace an inefficient management by a more desirable one. *See* Easterbrook and Fischel, *supra* note 2.

method adopted is substantially similar to that in India, through involvement of shareholders. In the United States however while buyback is generally permitted subject to disclosure and other requirements imposed by the SEC. There is no ban in the US on privately negotiated settlements. It must be noted the standard of good faith has to be observed by directors in all three countries, however it most frequent application to buybacks has been seen in the US. [50]

V. The Efficacy of Buybacks as a Takeover Defense

A share repurchase programme may often be used in combination with other defenses in order to raise the share price making it difficult, and altering the shareholder profile in a manner that the bid of the company making the takeover bid may not be accepted.[51] However, there are only specific situations where the technique may be utilized. For instance, buyback is contingent on the availability of a large amount of free cash available to the Corporation, and therefore it will be difficult for an already weak corporation (which is perhaps more susceptible to a takeover in the first place) to avoid a takeover by using this device.[52]

Further, the technique is fraught with several risks. For instance, the company will have to be extremely strategic in setting the price at which it seeks to buyback the shares. If the price set is below the threshold price the bidder is willing to pay for the shares otherwise it may actually facilitate the takeover by making the acquirer's offer more lucrative.[53] Further, it is strategically a poor technique to employ where the bidder is already the owner of a substantial proportion of the shares, as the repurchase will only increase the percentage of shares held by the bidder.[54] At the same time the repurchase may help the company

[50] It must be noted however that fiduciary duties of a director are well established in India and England as well, in the United States the application of the standard has been frequent in cases involving buyback. In England the test is considered to be stricter than mere fiduciary duty, although the standard of good faith is also applicable. *See* Gower and Davies *supra* note 7, at 717-718.

[51] Fleischer and Sussman, *supra* note 12, at 13-45.

[52] Stephen M. Bainbridge, Mergers and Acquisitions, 339 (2001).

[53] Fleischer and Sussman, *supra* note 12 at 13-45.

[54] It must be noted that in India for instance the repurchased shares have to be destroyed thus altering the proportion: *See* § 77 A (7). Therefore, if for instance the bidder already owns 30% of the stock, and the company purchases 25% of the shares in buyback and has to destroy the shares, the proportions of the shares in the hands of the bidder will be increased substantially to 40% thus causing a backfire. However if the same proportion of shares is held by a group opposed to the takeover or supporting the management, the takeover will become more difficult. In the United States the purchased shares need not be destroyed, but they become Treasury Stock, on which

acquire some of the shares that would otherwise have been purchased by the bidder.[55]

VI. Effect on Shareholders and Desirability

Whether or not defenses to takeovers generally, and particularly through the technique of buyback should be permissible is a vexed question in legal scholarship. The first question that arises is whether hostile takeovers per se are economically beneficial. One argument is that a hostile takeover permits the most efficient management to survive while the counter argument is that such takeovers only promote short-term profit maximization at the cost of long- term stability and innovation. The simple counter to both these views is that it would be a fallacy to characterize hostile takeovers as of a single type, there may be a number of motivations behind a takeover bid and consequences would vary accordingly.[56] The second issue is the degree of control that must be placed in the hands of the management as far as preventing takeovers is concerned, because it may be to perpetuate the management to the detriment of the shareholders.[57]

However it may often become necessary for the management to prevent the takeover to preserve the interests of the company as a whole, a classic instance being where the takeover is to strip the company of its assets. It appears therefore that buyback of shares should be the preferred mechanism of averting such a bid as, given the legal requirements in the three countries examined in this paper, the scheme depends greatly on shareholder approval. Further by its very nature, in this defense, shareholders have the most important role in determining their own

the management exercises no voting rights. Therefore the practical effect on the alteration of voting power and hence control over the country is substantially similar.

[55] For an economic analysis of the efficacy of buyback as a takeover defense *see* Laurie Bagwell et al., *Share Repurchase and Takeover Defense*, 22 RAND J. OF ECON. 72 (1991). The authors conclude that in certain cases buyback can increase the takeover cost to the acquirer thus causing a withdrawal of the bid. However this defense is seen to be effective mainly when it alters the marginal shareholder (who is readily willing to sell the shares to the bidder), where shareholder heterogeneity is large and when the takeover is not prompted by private benefit.

[56] For a comprehensive overview of the literature on this and related debates *see* John Coffee, *supra* note 24.

[57] Easterbrook and Fischel, *supra* note 2. The view of the authors is that a cash tender offer at a premium over the market price gives each shareholder the opportunity to obtain, with certainty, a return exceeding the current market value of the target's stock and therefore a takeover bid benefits the shareholder. The management must therefore not be permitted to avert it.

benefit.[58] It should therefore be preferred to the employment of a device where the management can proceed without shareholder approval.[59]

VII. Conclusion

It is evident from the above discussion that buyback is a well established defense to hostile takeovers, which operates by bringing about several effects that either make the takeover unviable or impossible for the potential acquirer. A study of the legal regime in the context of buyback as a takeover defense reveals that while specifics may vary, in general all three countries have attempted to make manipulations on the part of the management to retain control over the company at the cost of the shareholder more difficult by mandating that the shareholders either be involved in the decision making or be given adequate information to enable them to decide whether or not to accept the bid of the acquirer and whether to accept the management's bid of buyback. The success of a takeover bid also depends on the profile of the shareholders: whether they would sell to the highest bidder for a short term gain or continue with the existing management for long term benefit to the company. A buyback helps to avert a takeover even when the shareholder has a short-term outlook, as here if the company appropriately prices the scheme for buyback, the shareholder will be willing to sell even purely out of the profit motive.

Next, examining buybacks from the perspective of the policymaker, it must be noted that a buyback scheme, by its very nature is contingent on shareholder approval and action. A cross jurisdictional analysis reveals that if a buyback is carried out with shareholder approval and with the directors acting in the best interests of the company, then in principle, it should be allowed. If the primary cause for viewing takeover defenses with suspicion is that there is a possibility of misuse by directors, buybacks are relatively free of the risk as they depend on shareholder approval for success, apart from being heavily regulated legally even otherwise. Therefore, while being an effective tool to defeat hostile takeovers, buybacks carry minimum risk of the management acting solely for self-perpetuation and therefore are in keeping with the policy of the countries studied: that of ensuring that the management cannot bypass the shareholder. At the same time, the successful execution of the buyback defense is contingent on effective planning and prompt action of the management. Therefore, if the ultimate goal of corporate governance is to ensure a framework wherein the management and shareholders can work together to advance the interests of the company, buyback as a method of takeover avoidance is certainly suited to the purpose.

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[58] For an economic analysis of buyback as a takeover defense, *see* Sidharth Sinha, *Share Repurchase as Takeover Defense*, 26 J.F.Q.A. 233.

[59] John Coffee, *supra* note 24, at 1148.