

# HEDGE FUNDS

## GREENMAIL DISGORGEMENT STATUTES AND CORPORATE BY-LAW PROVISIONS COULD TRAP ACTIVIST HEDGE FUNDS

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When a hedge fund or other investor acquires a stake in a public company with a view towards profiting by causing the company to effect changes in its management or business, the restrictions imposed by state greenmail statutes may not immediately come to mind. Greenmail statutes were adopted in a different era of corporate takeovers and were intended to address what were arguably the more egregious practices of corporate raiders in the 1980s. Although most of these statutes are not relevant in today's environment, the greenmail statutes with the broadest reach—the disgorgement statutes—could impede the practices of today's activist hedge funds. In addition, while public concern about activist hedge funds has not to date been great, it is possible that public companies and state legislatures could further impede activist hedge fund activity through more aggressive by-law provisions and state statutes that build upon the existing disgorgement statutes.

### ORIGIN OF THE GREENMAIL STATUTES

In the heyday of hostile corporate takeover activity in the 1980s, corporate raiders widely targeted public companies with greenmail. Greenmail occurs when an investor acquires shares in a public company, threatens to take control of the company through a hostile acquisition or proxy contest, and then pressures the company to repurchase the investor's shares at a premium to market prices. Corporate raiders often engaged in greenmail for no purpose other than to make a quick profit by extracting what amounted to a corporate bribe from a vulnerable company. It is estimated that in 1984 alone, public companies paid \$3.5 billion in green-

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mail payments, with premium payments accounting for \$600 million.<sup>1</sup> In the following two years premium payments made by public companies remained in the hundreds of millions of dollars.<sup>2</sup> The victims of greenmail during this period included even prominent companies like Disney, Viacom and Texaco.<sup>3</sup> Although some commentators have defended the practice of greenmail,<sup>4</sup> it has been widely and commonly denounced.<sup>5</sup>

During the wave of greenmail activity in the 1980s, many state legislatures and public companies responded. Some states enacted straightforward prohibitions on greenmail, which generally restrict a corporation from repurchasing shares from a short-term investor at a price that exceeds market prices, unless the corporation's shareholders approve the repurchase. As many as five states today have statutes that impose straightforward prohibitions on the payment of greenmail.<sup>6</sup> Many other states adopted packages of anti-takeover measures, which included control-share acquisition provisions, merger moratorium provisions or other anti-takeover measures.<sup>7</sup> Although these types of anti-takeover provisions do not prohibit greenmail directly, they remove the leverage for the greenmail extortion payment by imposing significant impediments to a hostile takeover. Many public companies took action to protect themselves by adopting greenmail prohibitions, shareholder rights plans (also known as poison pills), or other anti-takeover measures in their own articles of incorporation or by-laws.<sup>8</sup>

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1. Christopher J. Bellini, *The Evolution of Greenmail: A Lawyer's Dilemma in Corporate Representation*, 2 GEO. J. LEGAL ETHICS 533, 534 (1988).

2. *Id.*

3. *Id.* at 539.

4. See e.g., Eric Engle, *Green with Envy? Greenmail is Good! Rational Economic Responses to Greenmail in a Competitive Market for Capital and Managers*, 5 DEPAUL BUS. & COM. L.J. 427 (2007).

5. See e.g., David Cowan Bayne, S.J., *Traffic in Corporate Control—Greenmail: Damages and the Disposition of the Bribe*, 78 U. DET. MERCY L. REV. 617, 619 (2001) (stating that greenmail is nothing other than corporate bribery); Tracy Greer, *The Hobbs Act and RICO: A Remedy for Greenmail?*, 66 TEX. L. REV. 647, 650 (1988) (noting widespread criticism of greenmail).

6. Arizona, Minnesota, New York, Tennessee and Wisconsin have enacted straightforward anti-greenmail statutes. Institutional Shareholders Services (n/k/a RiskMetrics), U.S. Proxy Voting Manual (2002), <http://governanceanalytics.com/content/menutop/content/subscription/usvmfiles/x6154.html>. Michigan repealed its anti-greenmail statute in 1997. *Id.*

7. P. R. Chandy, Charles M. Foster, Jr., Michael K. Braswell & Stephen L. Poe, *The Shareholder Wealth Effects of the Pennsylvania Fourth Generation Antitakeover Law*, 32 AM. BUS. L.J. 399, 400 (1995) (stating that the majority of the states has some type of anti-takeover statute); Mark E. Crain, *Disgorgement of Greenmail Profits: Examining a New Weapon in State Anti-Takeover Arsenals*, 28 HOUS. L. REV. 867, 868 (1991); Institutional Shareholders Services (n/k/a RiskMetrics), U.S. Proxy Voting Manual (2002), <http://governanceanalytics.com/content/menutop/content/subscription/usvmfiles/x6440.html>.

8. Although the U.S. Congress and the Securities and Exchange Commission considered a variety of anti-greenmail provisions, the only provision that was adopted was a federal fifty percent tax on the gains from greenmail payments. I.R.C. § 5881 (2008).

Two states—Ohio and Pennsylvania—took a novel approach in attacking greenmail, and adopted statutes with broad profit disgorgement provisions.<sup>9</sup> The Ohio and Pennsylvania disgorgement statutes allow a public company and its shareholders to recover profits from a person that threatens to acquire control of the company and then profits from the sale of the company's shares, whether such profits are extracted from the company directly or obtained through market trading.<sup>10</sup> Because of the breadth of these statutes, they have the potential to capture investor activity beyond the extraction of a corporate greenmail payment.

#### THE DISGORGEMENT STATUTES

The Ohio anti-greenmail statute, which applies to public companies incorporated in Ohio,<sup>11</sup> authorizes a corporation—or if the corporation fails to bring an action, a shareholder through a derivative action<sup>12</sup>—to recover any profits realized by a person from the sale of the corporation's shares when the shares are sold within eighteen months after such person proposed to acquire control of the corporation or publicly disclosed the intention or possibility of making such proposal.<sup>13</sup> No profits are recoverable if, at the time of the proposal or public announcement, the sole intention of the person who sold the shares was to succeed in acquiring control of the corporation and there were reasonable grounds to believe that such acquisition would occur.<sup>14</sup> Similarly, no profits are recoverable if the person's public disclosure regarding the intention or possibility of making a proposal to acquire control of the corporation was not made with a purpose of affecting market trading and did not have a material effect on market trading activity.<sup>15</sup>

The proposed acquisition of "control" that the Ohio statute addresses is broad. "Control" includes the power "to direct or cause the direction of the management and policies of the corporation, whether through the ownership of voting shares, by contract or otherwise."<sup>16</sup> Drawing upon language that is used in regulations of the Securities and Exchange Commission,<sup>17</sup> the Ohio statute's definition of control could be deemed to cover the ownership of as little as ten percent or even less

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9. See OHIO REV. CODE ANN. § 1707.043 (2008); 15 PA. CONS. STAT. ANN. §§ 2571-2576 (2008).

10. OHIO REV. CODE ANN. §1707.043(A); 15 PA. CONS. STAT. ANN. § 2575.

11. OHIO REV. CODE ANN. § 1707.043(A) & (H)(1).

12. OHIO REV. CODE ANN. § 1707.043(E)(1).

13. OHIO REV. CODE ANN. § 1707.043(A).

14. OHIO REV. CODE ANN. § 1707.043(B)(2)(a).

15. OHIO REV. CODE ANN. § 1707.043(B)(2)(b).

16. OHIO REV. CODE ANN. § 1707.043(H)(6).

17. See, e.g., 17 C.F.R. § 230.405 (2008) (defining "control" under the Securities Act of 1933); 17 C.F.R. § 240.12b-2 (defining "control" under the Securities Exchange Act of 1934).

of a corporation.<sup>18</sup> The definition of “control” could also be deemed to include not only the direct acquisition of a corporation’s stock, but the solicitation of proxies to vote on matters brought before the corporation’s shareholders.<sup>19</sup> To date, the Ohio statute has not been interpreted by the courts, and its potentially broad reach on these points is therefore uncertain.

The Pennsylvania anti-greenmail statute, which applies to public companies incorporated in Pennsylvania,<sup>20</sup> is substantially identical in effect to the Ohio statute.<sup>21</sup> However, the Pennsylvania statute reaches farther than the Ohio statute in two respects. First, the Pennsylvania statute more directly includes proxy contests within the definition of “control” with which the statute is concerned. The Pennsylvania statute exempts persons who acquire control through a proxy contest, but does not exempt persons who only announce an intention of engaging in a proxy contest for control.<sup>22</sup> Second, the Pennsylvania statute imposes strict liability on persons that attain “control” status for any trading profits made within eighteen months of attaining such “control,”<sup>23</sup> much like the strict liability contained in the short-swing profit provisions of Section 16(b) of the Securities Exchange Act of 1934, where profits made by a holder of more than ten percent of a public company’s shares during a six-month window are subject to disgorgement.<sup>24</sup> Like the Ohio statute, the interpretation of the Pennsylvania statute has not been the subject of court review.

A corporation may opt-out of the Ohio statute at any time by including an opt-out provision in its articles of incorporation or by-laws.<sup>25</sup> Corporations may opt-out of the Pennsylvania statute, but they have a much narrower opportunity to do so than in Ohio. A Pennsylvania corporation must have opted-out of the anti-greenmail statute within ninety days of adoption of the statute (that is, by July 26, 1990) or, if later, at the time the corporation first incorporates in Pennsylvania or first becomes a public company.<sup>26</sup> However, a corporation may also opt-out of the Pennsylvania statute in a particular instance by having an acquisition of stock approved by its board of directors or a disposition of stock approved by its board of directors and ratified by shareholders holding a majority of its shares.<sup>27</sup>

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18. See J. WILLIAM HICKS, *RESALES OF RESTRICTED SECURITIES*, SECURITIES LAW HANDBOOK SERIES, 33-40 (Thomson/West ed., 2008) (discussing “control”).

19. Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1093 & 1096 nn. 95 & 107 (1992).

20. 15 PA. CONS. STAT. ANN. §§ 2502 & 2575 (2008).

21. See 15 PA. CONS. STAT. ANN. § 2575.

22. 15 PA. CONS. STAT. ANN. § 2574(b)(3).

23. See 15 PA. CONS. STAT. ANN. §§ 2573 & 2575.

24. 15 U.S.C. § 78(p)(b) (2008).

25. OHIO REV. CODE ANN. § 1707.043(F) (2008).

26. 15 PA. CONS. STAT. ANN. § 2571(b)(2) (2008).

27. 15 PA. CONS. STAT. ANN. § 2571(b)(7).

In 2002, it was estimated that although a large percentage of Pennsylvania corporations—as many as fifty-nine percent—opted-out of the Pennsylvania statute, only approximately eleven percent of Ohio corporations have opted-out of the Ohio statute, the difference likely being due to the short timeframe during which a corporation may opt-out in Pennsylvania.<sup>28</sup>

#### TODAY'S ACTIVIST HEDGE FUND

The environment for corporate control is significantly different today than in the 1980s era of corporate raiders and greenmailers. Abusive takeover techniques are not as prevalent and greenmail has largely disappeared.<sup>29</sup> The presence of hedge funds has grown significantly, and billions of dollars have flowed into these funds. Today's hedge fund often takes a minority position in the public company in which it invests and, in an effort to enhance its returns, sometimes seeks to influence company management.<sup>30</sup> The activist hedge fund may seek to modify corporate governance or management practices at a company but more often seeks to have the company implement a specific corporate action such as a sale of the company, spinoff of a specific company division or business, a special dividend or other major transaction.<sup>31</sup>

In some cases, the corporate changes advocated by an activist hedge fund may be favorable in the long-term for shareholders generally. In many cases, however, the activist hedge fund attempts to turn a quick profit by targeting a vulnerable company and pushing for a significant corporate change or transaction with the aim of having an immediate impact on the company's stock price or profiting from the transaction that is ultimately completed. In other cases, the hedge fund may engage in activism with its only purpose being to create the appearance that beneficial corporate change is imminent at the targeted public company. Regardless of the motive of the activist hedge fund, its activities can dramatically influence trading activity in a company's stock and often have a significantly disruptive effect on the company. Its activities can impose heavy costs on the company, in the form of legal and other costs incurred to fight a control contest as well as opportunity costs incurred through a distracted management—costs that some may view to be no less troublesome than a direct greenmail payment.

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28. Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the 'Race' Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1859 (2002).

29. David Manry & David Stangeland, *Greenmail: A Brief History*, 6 STAN. J.L. BUS. & FIN. 217, 235 (2001); William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1427-28 (2007).

30. See Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 683 (2007).

31. *Id.* at 722-23.

## THE HEDGE FUND TRAP

When a hedge fund takes a significant stake in a public company, it is confronted with a variety of legal restrictions and obligations. The hedge fund must consider the ownership thresholds that could trigger a company's poison pill, anti-takeover provisions contained in the company's articles of incorporation or by-laws, or state anti-takeover laws such as control share acquisition statutes, merger moratorium statutes and anti-greenmail statutes. The hedge fund must also address the potential filing and disclosure obligations that arise under the federal securities laws, such as Forms 3 and 4 ownership reporting requirements under Section 16 of the Securities Exchange Act of 1934<sup>32</sup> and Schedule 13D filing obligations under Section 13(d) of the Securities Exchange Act of 1934.<sup>33</sup>

Although the hedge fund may trigger the greenmail disgorgement statutes through a variety of public statements, the disclosure obligations under Schedule 13D lay the biggest trap. If the hedge fund acquires more than five percent of a public company's shares—or forms a group with other shareholders that together hold more than five percent of the company's shares—it is required to file a Schedule 13D with the Securities and Exchange Commission within ten days.<sup>34</sup> Among other disclosures required to be made in a Schedule 13D, including information about the hedge fund, the number of shares of the target company it owns and any contracts or understandings between the hedge fund and any other party relating to the company's shares, the hedge fund must state the purpose for its investment and any plans or proposals it has for the company.<sup>35</sup> Specifically, the hedge fund must disclose if it has any plans or proposals relating to or that would result in an extraordinary corporate transaction by the company, a sale of the company, a material change in the company's corporate structure, a material dividend, or any change in the board of directors or management of the company.<sup>36</sup> The hedge fund must also disclose if it has any plans to dispose of any of its shares of the company.<sup>37</sup>

If there are any material changes or developments in the investor's Schedule 13D disclosures—including in any of its plans or proposals for the subject company or its intentions to engage in a proxy contest with

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32. 15 U.S.C. § 78(p)(a) (2008).

33. 17 C.F.R. § 240.13d-1 (2008).

34. 17 C.F.R. § 240.13d-1(a). In lieu of filing a Schedule 13D, an investor may in general file a Schedule 13G, which contains less extensive disclosure requirements, if the investor is a qualified entity or beneficially owns less than twenty percent of the corporation's equity securities and has not acquired the securities with the purpose of changing or influencing control of the corporation. 17 C.F.R. § 240.13d-1(b)(1) & (c). In the Schedule 13G, the investor must certify that it did not acquire the securities for the purpose of changing or influencing the control of the corporation. 17 C.F.R. § 240.13d-102, Item 10.

35. 17 C.F.R. § 240.13d-101, Item 4.

36. *Id.*

37. *Id.*

management—the hedge fund must promptly disclose such changes or developments in an amended Schedule 13D.<sup>38</sup> Because misstatements and omissions in a Schedule 13D or the failure to update a Schedule 13D when material developments occur can give rise to federal criminal and other penalties, investors should and typically do take their Schedule 13D filing obligations very seriously.

If a hedge fund plans to pressure a company to effect a fundamental transaction, it is required to disclose these plans in its Schedule 13D. If the hedge fund plans to apply this pressure by threatening to replace the incumbent board through a proxy contest or acquire the company directly—both of which are typical hedge fund pressure tactics—the hedge fund will also be required to disclose these threats or planned threats in its Schedule 13D. The threat to solicit proxies or directly acquire the company—made public through the Schedule 13D—constitutes the type of public disclosure that triggers the greenmail disgorgement statute. The hedge fund may, of course, trigger the disgorgement statute through other public disclosures, such as press releases issued to influence other shareholders or apply further pressure to management, but the hedge fund's ongoing Schedule 13D reporting obligations remain present through every public action taken by it during the course of its investment.

In whatever manner the hedge fund publicizes a takeover or proxy contest threat, any sales by the hedge fund at a profit during the statutory window period will raise the risk of possible disgorgement of profits. Defenses may exist under the disgorgement statutes, but they are unlikely to be available to the hedge fund if it did not intend to ultimately carry through on its threats to obtain control of the company or made its threats haphazardly. In this scenario, the greenmail disgorgement statute takes aim at the hedge fund when its actions are least defensible—when it threatens a takeover or control contest only in support of its objective to achieve short-term trading profits.

#### POTENTIAL EXPANSION OF THE HEDGE FUND TRAP

Activist hedge funds have not raised the same level of public concern as the corporate raiders and greenmailers of the 1980s. Activist hedge funds often appear to be promoting positive structural and governance changes at the public companies to which they have devoted their efforts. Nevertheless, in some instances the pressure from an activist hedge fund has been nothing more than an attempt to effect quick superficial changes that may not be in the long-term interest of a public company and its shareholders. In addition, the public companies that have come under attack from a seemingly well motivated hedge fund might question whether hedge funds, with their notoriously short-term investment horizon and lack of hands-on operational experience, are the best source of

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38. 17 C.F.R. § 240.13d-2(a) (2008).

strategic management advice. Might it make sense to allow hedge funds to voice their concerns—as shareholders and through board positions—while having legal restrictions that prevent them from gambling on quick-fix corporate changes in hopes of producing short-term profits?

The Ohio and Pennsylvania disgorgement statutes could be used more proactively towards that end. These states could also expand their statutes to more specifically address the threatened use of a proxy fight against incumbent management to shake-up a company's stock price. Other states could adopt provisions similar to those in Ohio and Pennsylvania. Concerned public companies could protect themselves by adding provisions in their by-laws that are similar in effect to the Ohio and Pennsylvania statutes. Although it is doubtful that a corporate by-law provision that imposes a disgorgement remedy would be enforceable, it is possible that a company could achieve the same effect through a right of first refusal—allowing the company to repurchase the offending shareholder's shares at the price paid by the shareholder—with triggers similar to the disgorgement statutes. State legislation and corporate by-law provisions could also be drawn to include strict liability provisions for short-swing profits made by significant shareholders, similar to Section 16 of the Securities Exchange Act of 1934, but perhaps with longer window periods like the eighteen-month period in the Pennsylvania statute.

Whether any of these scenarios are likely or not, activist hedge funds at a minimum need to be mindful of the fact that more than a few of the public companies in which they invest may be incorporated in Ohio or Pennsylvania, and therefore may have a little more protection from hedge fund activism than at first might be suspected.

#### CONCLUSION

Although views regarding the practices of today's activist hedge funds may vary, public concern about their activities has not risen to the level that inspired the anti-takeover legislation and corporate protective provisions that were first implemented in the 1980s. However, the anti-takeover provisions that were adopted in the much different era of the 1980s—including the greenmail disgorgement statutes—continue today as an impediment to the practices of activist hedge funds. If public companies or state legislatures determine to tip the balance of corporate control away from the activist hedge fund, the greenmail disgorgement statute stands as a model of what could be adopted to restrict the activist hedge fund at its worst—when it threatens a control contest in support of a plan to turn a quick trading profit.