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# Corporate Distributions to Shareholders in Delaware and in Israel

Anat Urman
*University of Georgia School of Law*

ANAT URMAN
Corporate Distributions To Shareholders In Delaware And In Israel: Cash Dividends And Share Repurchases.
(Under the Direction of Professor CHARLES R.T. O'KELLEY)

This thesis considers the corporate legal systems of Israel and Delaware as they address the subject of corporate distributions to shareholders. The thesis reviews the significance of cash dividends and the acquisition by corporations of their own stock, in the management and survival of corporations, the effect they have on the disposition of creditors, and the extent to which they are restricted by operation of law.

The thesis demonstrates how dividends and share repurchases may translate into a transfer of value from creditors to shareholders. It considers the effectiveness of the legal capital in securing creditors' interest, and concludes that the legal capital scheme presents no real obstacle to distributions.

It is further concluded that despite the recent corporate law reform in Israel, Delaware's corporate law system continues to surpass Israel in flexibility and broad approach to distributions. Nevertheless it is expected that Israeli courts will consider Delaware's methodology on the matter.

INDEX WORDS: Debt, Distribution, Dividend, Equity, Equity cushion, Fiduciary, Greenmail, Insolvency, Legal capital, Leverage, Nimble dividend, Par value, Recapitalization, Redemption, Restrictive covenant, Repurchase, Surplus, Takeover.

CORPORATE DISTRIBUTIONS TO SHAREHOLDERS IN DELAWARE AND IN ISRAEL: CASH DIVIDENDS AND SHARE REPURCHASES

by

ANAT URMAN

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ANAT URMAN

Approved:

Major Professor: Charles R.T. O'Kelley

Committee: Fredrick W. Huszagh
Charles R.T. O'Kelley

Electronic Version Approved:

Gordhan L. Patel
Dean of the Graduate School
The University of Georgia
December 2001

DEDICATION

To my parents Malka and Menachem Urman, and to Ron Kalfus.
Thank you for your support.

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# CHAPTER 1

## INTRODUCTION

### I. Thesis Background

Israel is small country with very few natural resources, facing difficult political scenarios. Despite these adverse conditions, Israel has reportedly sprouted into the world's second most important high-tech cluster after Silicon Valley.[1] In a country of only six million people, there are nearly as many Israeli companies listed on the NASDAQ (National Association of Securities Dealers Automated Quotation System) as there are European companies.

The government of Israel has taken an active role in promoting the county's technological capabilities.[2] The high-tech sector has become a central element in Israel's economy, so much so, that its continued success is central to Israel's economy.

However, it has become increasingly difficult to attract foreign investors to participate in ventures within Israel. If fact, Israel's high-tech industry is reportedly losing its business to foreign countries.[3] In the past several years, over ninety percent of

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[1] Roger Abravanel, *The Promised Economy*, THE MCKINSEY QUARTERLY, 2001 Number 4 (hereinafter The McKinsey Quarterly). *Also available at*, http://www.mckinseyquarterly.com/article_abstract.asp?tk=:1108:7&ar=1108&L2=7&L3=10.

According to The McKinsey Quarterly, during the year 2000, Israeli high-tech start-ups attracted more investment per head than any other country in the world. Israeli high-tech start-ups attracted $3.2 billion in capital investment, most of which foreign. This amounts to a 30-fold increase in investments in a period of only three years.

[2] Subsidizing and setting up labs, incubators and seed-money venture capital funds.

[3] Many companies transfer their business centers and management teams out of Israel. Even when the research is performed in Israel, the development products are transferred to related companies overseas.

the new start-up companies that were formed in Israel, incorporated as foreign companies,[4] many of those in the U.S., a majority of which in Delaware.

Why is it then that Israel, an incubator for world-class technological innovation, is struggling to prevent companies from immigrating to Delaware?

One known turnoff for choosing Israel as a jurisdiction, is its unique system of corporate law. A major source of funding flowing into the venture capital industry in Israel originates from U.S. investors who do not believe in the Israeli system. Much pressure is, therefore, placed on Israeli entrepreneurs to set up their companies in the U.S. rather than Israel. Clearly, investors are likely to choose a jurisdiction whose laws are simple and most advantageous. Indeed, we see that among worldwide systems, those that dominate are systems that have the easiest, clearest, simplest, and most worthwhile laws governing economics, securities, income tax, and companies. Such systems compete in the global market because they are compatible with worldwide leading codes.

The new 1999 Israeli Companies Law, on which work commenced fifteen years ago, was intended to serve this purpose precisely. However, by introducing an innovative and revolutionary code, legislators have, in effect, set back Israel's competitive position. The new Companies Law is widely criticized as being less clear, less simple, less predictable, and less user-friendly than its foreign counterparts.

Delaware, which has become a corporate haven for many Israeli corporations, has been offering an attractive legal landscape for incorporation for over two decades.

[4] Ron Tira, *Bye-Bye-Tech*, GLOBES ISRAEL'S BUSINESS ARENA, June 7, 2000.

In fact, a large number of U.S. and international corporations, headquartered elsewhere, are incorporated in Delaware.[5]

Delaware is known to have one of the most flexible and convenient series of company regulations in the world. Over the years, Delaware has led the development of sophisticated company regulations and a reform of bureaucratic mechanisms that have made it one of the most convenient places to incorporate.

First, it offers a finely developed corporate statue that presents companies with a convenient legal environment and an extensive statutory protection for corporate officers and shareholders. Delaware's legislators and the Bar Association's Section on Corporate Law, constantly revise and update the corporate statutes so that they remain dynamic and flexible to surging needs.

Second, Delaware maintains a separate pro-business corporate law court system. On the bench of the Delaware Court of Chancery, sit judges appointed for their extensive knowledge of corporate law. Over two hundred years of legal precedent lend Delaware law with predictability and clarity that are fundamental to its popularity.

Israeli legislators have long recognized the advantages Delaware offers to Israeli companies. An unprecedented effort is thus being made to produce a competitive model for Israel.

[5] The State of Delaware has been the state of choice for incorporation for more than 308,000 companies, a state of only 1.5 million residents. Sixty percent of the Fortune 500 companies and fifty percent of the companies listed on the New York Stock Exchange are also incorporated in Delaware. *See* Delaware Division of Corporations (visited Sep. 9, 2001), a*lso available at* http://www.state.de.us/corp/.

## II. The Significance Of Distributions To Corporate Constituencies

> "[T]here is no easier way for a company to escape the burden of a debt than to pay out all of its assets in the form of a dividend, and leave the creditors holding an empty shell." (emphasis added) Fischer Black, 1976.[6]

Because of the legal structure of corporations, whereby shareholders' liability is limited to their respective investment,[7] it is suggested that once the corporation becomes leveraged or financially distressed, shareholders[8] have an interest in intensifying distributions from the corporation's treasury to external outfits.[9] Because the shareholders are normally not accountable beyond their respective investment for the debts that the corporation runs up, a diminution of corporate assets, subsequent to the purchase of debt will, thus, translate into a direct transfer of value from the creditors to the shareholders.

Creditors remain fixed claimants, regardless of the prosperity that the corporation experiences. Although debt has an absolute repayment priority over equity,[10] there are, nevertheless, numerous ways in which corporate assets may be dispersed, long before creditors can take legal action to protect their interests.

Two common ways to distribute cash to shareholders are through the reacquisition of stocks and the issuance dividends. Creditors would ideally covenant to restrict the corporation from carrying out sporadic distributions, to assure, to the extent

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[6] Fischer Black, The Dividend Puzzle, 2 J. PORTFOLIO MGMT. 5, 7 (Winter 1976).

[7] Whether the shareholders paid the corporation for their shares or whether they have simply contracted to do so, their financial exposure with respect to any liabilities that the corporation may incur is limited to the amount that they have paid the corporation or have agreed to pay for their equity. *See* CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS, CASES AND MATERIALS 157 (3d ed. 1999).

[8] And in certain situations also other corporate constituencies.

[9] *See* BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL 5 (3d ed. 1990) [hereinafter MANNING & HANKS]; Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45, 48 n.9 (1998).

[10] O'KELLEY & THOMPSON, *supra* note 7, at 566.

possible, that the corporation maintains a sufficient volume of assets throughout the life of the debt.

Corporate law systems secure the objectives of the creditors, to some extent, by imposing limitations on the power of corporate constituencies to carry out distributions. At the same time, a delicate balance must be preserved between the interests of the creditors and that of the equity owners. A corporate law system that overprotects creditors might become a less attractive choice of domicile for investors.

The availability of distributions becomes a main consideration weighing with investors as they decide where to incorporate their business. Furthermore, it has been observed that increased legal certainty and predictability attract global capital, and produce benefits for the domestic economy.

This thesis pauses to consider the achievements and shortcomings of the corporate legal systems of both Israel and Delaware, U.S.A., as they address the issue of corporate distributions to shareholders. The thesis considers the 1999 corporate law reform in Israel, and reviews the significance of dividends and stock repurchases in the management, development, and survival of the corporate enterprise.

While common law remains as the base of Israeli corporation law, the Israeli legal system is influenced by other common law jurisdictions, particularly by U.S. jurisdictions. From the standpoint of comparative law, Delaware's corporation law, which is renowned for being an attractive choice of domicile for businesses, serves an excellent basis for comparison.

### III. Israel's Corporate Law System

Israeli corporation law derives primarily from English law. From 1917, until the declaration of the State of Israel in 1948,[11] Israel (then named "Palestine") was subject to a British mandate. During the British rule, various laws were enacted encompassing a broad array of commercial decrees, including company laws. When instituting commercial decrees, the British High Commissioner drew upon the English law, making only minor changes. The Companies Ordinance,[12] enacted in 1929, was virtually a replica of the English Act of Parliament. As a common law jurisdiction, the existing *English* common law served as the basis for applicable precedent.

To prevent the creation of a legal "vacuum" subsequent to the establishment of the State of Israel, the parliament announced that mandatory laws, which were not averse to the fundamental principles of the newly founded state, would remain in force. Inevitably, the Companies Ordinance, which was ratified upon the foundation of Israel, was copied in its entirety from the English Companies Act. It was extensively amended, though, in 1983,[13] until it was replaced with a new cohesive corporate code in 1999, the Companies Law.[14]

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[11] On November 29th, 1947, the United Nations General Assembly passed a resolution calling for the establishment of the State of Israel. On May 14, 1948, on the day in which the British Mandate over Palestine expired, the State of Israel was officially declared.

[12] "An 'ordinance' is a term used to describe a statute promulgated in Palestine, under the British Mandate, by the mandatory High Commissioner. Although ordinances are, by and large, administrative decrees, they are regarded as normal statutory materials and enjoy the same hierarchical status as later parliamentary laws passed by the Knesset [Israel's parliament]." Uriel Procaccia, *Crafting a Corporate Code from Scratch*, 17 CARDOZO L. REV. 629, 629 n.1 (1996).

[13] PKUDAT HA'HAVAROT (NOSAH HADASH) [The Companies Ordinance (New Version)], 1983 [hereinafter The Companies Ordinance (1983)].

[14] HOK HA'HAVAROT [The Companies Law], 1999, S.H. 189 [hereinafter The Companies Law, 1999].

The new Companies Law was an attempt to fine-tune Israel's corporation laws with global commercial trends. One aspect that the new Companies Law attempted to address was the conditions upon which distributions are made to shareholders. The Companies Ordinance, 1983, contained rigorous rules against distributions. As a general rule, the Companies Ordinance prohibited distributions, with some exceptions. The new Companies Law, contrary to the Companies Ordinance, generally authorizes distributions, with few limitations.

However, in attempting to resolve a series of ongoing uncertainties regarding dividends and share repurchases, legislators have managed to generate further uncertainty. Although some of the changes designed to alleviate the strictures on distributions were well needed, others remain particularly inflexible as compared with parallel laws elsewhere.

### IV. Thesis Structure

Imposing restrictions on corporate distributions is one of the primary solutions offered by corporation codes for the conflict of interest between equity holders and debtholders.[15] Chapter 2 of the thesis examines the conflict between debt and equity and its manifestation in investment theories. It is suggested that because shareholders and debtholders share risk asymmetrically, shareholders of leveraged firms have a liking for high-risk ventures, particularly when the corporation is near or on the verge of

[15] The thesis focuses on the disposition of unsecured creditors. A secured creditor is one who has extracted some type of "collateral" from the corporation. Thus, the interest of the secured creditor lies in a particular asset, which the corporation may not dispose of voluntarily without the consent of the creditor. Where the corporation's assets are insufficient to pay all outstanding claims (secured and unsecured), general creditors may be left unpaid, while secured creditors will receive payment owing to them to the extent of their security prior to all other creditors. The general creditors have no claim against the value of the secured assets except to the extent that the value of the secured assets, exceed the secured creditor's claim. MANNING & HANKS *supra* note 9, at 6.

insolvency. Chapter 2 further considers the mechanisms for eliminating investment risks and the significance of the equity cushion in that process.

Chapter 3 of the thesis focuses on the legal capital rules which shape, to a large extent, the provisional limitations on distribution. The rules of the legal capital model address the questions of how much, and under what circumstances, may corporate treasury assets be distributed to shareholders. Chapter 3 examines several distribution-oriented provisions and their effect on corporate constituencies.

Chapter 4 critically evaluates the effectiveness of the legal capital model in protecting creditors' interests, versus the strain they impose on the corporation and other constituencies.

Chapter 5 considers the vital role that dividends and share repurchases play in commercial planning. We revisit the most reiterated financial theories and legal criticisms over the role of dividends and share repurchases in the vitality of corporations.

The analysis in Chapter 5 provides the setting for appreciating the legal developments that Israel experienced during the 1999 legal reform, fully examined in Chapter 6. We compare in Chapter 6 the statutory disposition of Delaware corporations and Israeli corporations, and consider the impact that Delaware case law might have on legal interpretation in Israel. Chapter 6 mainly considers the legitimacy of several methods of repurchases and breaches of directorial duties.

Finally, Chapter 7 examines the scope of liability that Israel and Delaware impose on shareholders and directors for improper distributions, and the extent to which creditors can impede distributions that have a negative effect on their status.

## CHAPTER 2

## THE CONFLICT OF INTEREST BETWEEN THE SHAREHOLDERS AND THE CREDITORS

### I. Introduction

Theories on legal capital[16] and the corporate enterprise have long recognized the tension between shareholders and creditors, whenever debt is issued to the corporation.[17] These theories propose that once the corporation is leveraged, shareholders have an interest in minimizing the quantity of assets to be committed to the corporation's treasury, and in maximizing the volume of distributions from the corporate treasury.[18]

Because of the legal structure of the corporation, whereby the shareholders' liability and risk are limited to their investment,[19] the creditors of the corporation seek reasonable assurances from the corporation that it will have sufficient assets towards the payment of their claims when they become due. Having lent the corporation money, the creditors would generally like the corporation to maximize its pool of assets and secure them throughout the life of the debt.

[16] For and extensive review of the legal capital model see discussion infra pp. 18-26.
[17] Barondes, *supra* note 9, at 48 n.9.
[18] MANNING & HANKS *supra* note 9, at 5; Barondes, *supra* note 9, at 48.
[19] *See* O'KELLEY & THOMPSON, *supra* note 7, at 157:

> Normally, a shareholder has no obligation or liability to the corporation or its creditors beyond the amount she paid for the shares. This concept, known as "limited liability", allows a shareholder to risk only a predetermined amount of capital in each corporate investment, instead of potentially risking her entire wealth as would be the case if shareholders were personally liable for a corporation's debts.

## II. The Conflict Between Debt And Equity

Finance theories highlight three predominant differences between debt and equity: the nature of the claim as fixed or residual, repayment priority, and the governance rights associated with each.

The shareholders of the corporation are not the owners of the corporation's property, but have the right to share in the earnings of the corporation, as they may be declared in "dividends".[20] Upon dissolution the shareholders are entitled to a proportionate share in the residual assets of the corporation.[21] Thus, while the shareholders collect the full upside of their investment (after the lenders are repaid), they must accept the downside of a poor investment. If no income remains after the lenders are reimbursed, the equity holders receive no return and lose their invested capital.

The creditors of the corporation lend the corporation funds and contract to receive the repayment of the principal plus an agreed rate of interest. Regardless of the prosperity that the corporation may enjoy, lenders, as fixed claimants, will be entitled only to the repayment of a fixed amount.

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[20] For the term "dividend" see DEL. CODE ANN. tit. 8 § 170 statutory notes (2001)- Penington v. Commonwealth Hotel Constr. Corp., 17 Del. Ch. 394, 155 A. 514 (1931) ("Payment to stockholders as return upon their investment is, in general, termed a dividend . . . . Dividend is the sum of money or portion of divisible thing to be distributed according to some fixed scheme."), and see id. Bryan v. Aikin, 10 Del. Ch. 446, 86 A. 674 (1913):

> The stockholder does not, and cannot, own the property of the corporation, or even the earnings, until they are declared in the form of dividends, but when they are so declared, whether in cash, or in stock purchased or newly created, they are not capital of the company, but a distribution of profits which were made by the use of the corporation' s capital in the prosecution of its business.

[21] Equity investors contract to receive the remaining income of the firm after expenses, taxes, debt installments, and after higher priority claims are satisfied.

In terms of priority,[22] an equity investment affords the shareholders a claim to share in the assets and net income of the corporation, after expenses, taxes, and higher-priority obligations are paid.[23] Equity investors may receive periodic payments in the form of dividends, pro rata to their investment share. Such periodic payments are voluntary and have no maturity date. Compared to debt, an equity interest is viewed as a more risky investment because it awards dividends only after all higher-priority claims are repaid.[24]

Debt has an absolute repayment priority over equity. It is a fixed sum with a maturity date.[25] In the event of dissolution, shareholders are last in line to collect. However, while the creditors' position in the hierarchy of claim is superior to the shareholders, the creditors must still compete among themselves for priority in the right of payment.[26]

As a result, in the absence of a special agreement with the corporation, the disposition of individual creditors will be adversely affected by an increase in the

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[22] "Priority" in the sense of hierarchical disposition.

[23] O'KELLEY & THOMPSON, *supra* note 7, at 566.

[24] Equity is considered more risky than debt for various reasons of which two are central. First, any return on equity, either through the resale of securities or periodic payments, is uncertain. In contrast to debt investments, where the investment yields a fixed return, the return from an equity investment varies with the fortunes of the firm. By definition, then, equity returns have a greater variance or range of expected returns than the returns associated with a debt investment. The greater the variance of a project, the less the project is worth to the typical risk-averse investor. *See* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 80-87 (2d ed. 1995) (hereinafter GILSON & BLACK).

[25] Typically, repayments are made in equal installments until the debt is finally repaid at a specified date, rather than as a lump sum at maturity date.

[26] Lenders have an automatic right to payment before the next most junior claim may be paid. MANNING & HANKS *supra* note 9, at 6:

> Creditors compete among themselves for an interest in specific assets of the debtor, and to the extent they are unable to achieve a fully - secured position, for priority in right of payment. The corporate debt may consist of several classes of undertakings differently ranked relative to one another. Some claims may be subordinate to some or all other claims of specific creditors or classes of creditors.

aggregate outstanding claims against the debtor corporation.[27] Furthermore, as the leverage of the firm increases, so does the likelihood of bankruptcy.

In order to secure their position in the collection procession, creditors may require the corporation to afford them the position of a "senior debtor", to which all other claims or classes of claims are subordinate, i.e. "junior". Naturally, the ability of a creditor to extract such a commitment from the corporation is susceptive to a competitive market.

Prior to the purchase of the debt, the shareholders of the non-leveraged firm share the upsides of their investment while their risk is limited to their initial contribution. If the enterprise is unsuccessful, these initial contributions would be used to pay for the corporation's outstanding obligations. While shareholders' appetite for risk may vary according to personal preferences[28] and depending on the category of the corporation,[29] they will arguably be less pronged to take risky projects that could place their investment at risk of loss.

Debtholders will negotiate the terms of the debt[30] to reflect their view on the risk of default according to the financial well-being of the corporation at the point of negotiations. Arguably, they will have already taken into consideration management's and shareholders' expected behavior, following the issue of the debt.

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[27] Claim dilution, or the later issuance of the same or higher-priority debt, is an agency cost associated with debt. As more debt of the same or higher priority is issued, the value of the original debt decreases due to the heightened risk of nonpayment. Lenders can protect against claim dilution by demanding a security interest in the debtor's assets or by requiring covenants restricting the subsequent issuance of equal or higher-priority debt.

[28] On risk aversion see GILSON & BLACK, *supra* note 24, at 80-87.

[29] On closely held corporations see Barondes, *supra* note 9, at 51 n.16 (a closely held corporation may be formed for the purpose of assuming a risky project depending on the averseness of the members to risk. Where the members are not risk averse they may prefer devising the risk between a small group of members and enjoy, if the project is successful, higher percentages of profit. Public investors share a small portion in the downfall and as a result may be more willing to take riskier projects while large block holders may be more risk averse).

[30] *E.g.*, interest rate and period of debt.

### i. Overinvestment theory

Legal capital theories suggest that once debt has been sold to the corporation, the return to shareholders for pursuing risky strategies increases by virtue of the disproportionate allocation of risk between the shareholders and debtholders.[31] The shareholders of a highly leveraged firm get all of the increased upside potential from taking a large risk. Much of the increased downside is borne by the debtholders.

Gilson and Black provide a helpful analysis of the conflict between debt and equity by applying the options perspective.[32] When a firm purchases debt, the shareholders can be seen as having sold and non-leveraged firm to the debtholders in return for the proceeds from issuing the debt, and a call option to repurchase the non-leveraged firm by paying off the debt.[33] The value of the shareholders' call option on the debt is determined by the variance (measure of risk) in the future value of the firm. The higher the variance, the greater the expected return, but so too the expected loss. Since shareholders' liability is limited to their stock contribution, high variance projects shift a predominant part of the risk (depending on how leveraged the firm is) to the bondholders.

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[31] Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131 (1989) (hereinafter Fischel, *Lender Liability*). *See also* Brent Nicholson, *Recent Delaware Case Law Regarding Director's Duties to Bondholders*, 19 DEL. J. CORP. L. 573, 585-86 (1994) (discussing Chancellor Allen's opinion in the landmark case of *Credit Lyonnais Bank Netherland, N.V.* v. *Pathe Communications Corp.*, Civil Action No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991)):

> In footnote 55, Chancellor Allen discussed the tension that sometimes exists between creditors and shareholders, particularly when insolvency threatens the corporate existence. For instance, shareholders may desire higher risk strategies that reduce the certainty of having funds available to pay the debtholders. Debtholders, however, clearly would prefer a management policy which preserves funds sufficient to pay the corporate debt.

[32] On options see generally GILSON & BLACK, *supra* note 24, at 231-43.

[33] *Id*. at 244. On the repayment date, if the firm's assets exceed the repayment price, the shareholders will "exercise their option" to repurchase the non-leveraged firm by repaying the debt. If the value of the firm's assets is lower than the repayment price, the equity holders will not exercise their option (by defaulting on the debt).

Gilson and Black provide a very helpful illustration on how the factors that determine the option value affect the incentives of both parties:

> Suppose that firm X has assets of $100, all invested in Treasury bills, and outstanding debt of $90. If the firm keeps its funds in treasury bills, it will be able to pay the debt for sure, so the debt will be worth $90 and the stock will be worth $10. Suppose though that the stockholders find a project that requires a $100 investment, and has a 50% chance of returning $200 and a 50% chance of returning $0. The expected return on the $100 investment is $100.
>
> The expected payoff to the stockholders from this investment is strongly positive. If the investment pays off, they repay the debt and are left with stock worth $110. If the investment doesn't pay off, the stockholders default on the debt and are left with $0. Since both outcomes are equally likely, the expected payoff is $55 . . . .

| | Before Risky Investment | After Risky Investment[34] |
|---|---|---|
| Stock value | $10 | (.50 x $110) + (.50 x $0) = $55 |
| Debt Value | $90 | (.50 x $90) + (.50 x $0) = $45 |
| Firm Value | $100 | (.50 x $200) + (.50 x $0) = $100 |

> The stockholders' gain, though, is the debtholders' loss. If the investment pays off, the debtholders receive $90. If the investment doesn't pay off, they are left with a claim on a worthless firm, worth $0. Since both outcomes are equally likely, the expected payoff is $45.[35]

Gilson and Black conclude that the shareholders have an incentive to cause the firm to take riskier investments than would otherwise be optimal for a non-leveraged firm.[36]

Thus, when the equity of the firm is small, as in the instance where the value of the firm equals its outstanding debt, the debtor has nothing to lose, and everything to

[34] The expected return on a project under uncertainty is the expected return upon success multiplied by the probability of success, plus the expected return upon failure multiplied by the probability of failure.

[35] GILSON & BLACK, *supra* note 24, at 245.

[36] *Id*. at 244.

gain, from engaging in high-risk projects.[37] If the strategy succeeds, the shareholders will reap most of the benefits vis-à-vis the rise in the market value of the firm. If the strategy fails, the market value of the firm will fall, but the creditors will bear the loss.

#### ii. Underinvestment theory

The incentives of equity holders to cause the corporation to enter into high risk ventures fortifies when the corporation is near or on the verge of insolvency.[38] On the other hand, some argue that an insolvent firm will in fact under-invest in projects, i.e., due to indifference, the firm will fail to enter into transactions that would be value-increasing.[39] The theory is that shareholders will not invest equity, or make the efforts necessary, for the firm to take positive net present value projects. This is because the returns will be realized not by the shareholders but by the creditors, unless, of course, the returns from the project are expected to exceed the value of the debt. The heavier the leverage, the more likely the aforementioned behavior will occur.

## III. Eliminating Investment Risks And The Function Of The Equity Cushion

Ultimately, both the debtors and the creditors have a mutual interest in producing a profit, and both wish to risk as little as possible in the process.

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[37] Fischel, *Lender Liability*, *supra* note 31, at 134.

[38] *See* Barondes, *supra* note 9, at 49 n.10 for a discussion on the subject of insolvency. *See also* discussion *infra* pp. 78-79. For the proposition that the incentive to pursue risky investment strategies increases at insolvency or near insolvency see Fischel, *Lender Liability*, *supra* note 31, at 134; Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575, 576-77 (1995); Katherine H. Daigle & Michael T. Maloney, *Residual Claims in Bankruptcy: An Agency Theory Explanation*, 37 J.L. & ECON. 157, 157 (1994) (stating that shareholders' incentives to engage in excessive risk-taking are "particularly acute" when the firm is distressed); Barondes, *supra* note 9, at 49 ("These incentives can become very powerful for a corporation approaching insolvency, because the shareholders may essentially be indifferent as among all outcomes involving a non-positive return, negative returns of a distressed corporation being almost entirely borne by the creditors.").

[39] Daniel E. Ingberman, *Triggers and Priority: An Integrated Model of the Effects of Bankruptcy Law on Overinvestment and Underinvestment*, 72 WASH. U. L.Q. 1341, 1342 (1994); Fischel, *Lender Liability*, *supra* note 31, at 134-35.

Since equity owners cannot be held accountable for liabilities exceeding their initial contributions, then theoretically, shareholders could eliminate their risk by causing the corporation, subsequent to its acquisition of debt, to distribute to them assets in the value of their investment. Arguably, ensuring that enough assets remain in the firm to satisfy the creditors' claim protects the creditors' interests.[40] The value of the shareholders' investment is sometime referred to as the creditors' "equity cushion".[41] The larger the equity cushion of the firm, the lower the risk of loss to the lender upon default, because lenders have the first claim on the firm's remaining assets, including the equity cushion.

As illustrated above, once the debtor decreases the equity cushion (through asset withdrawal),[42] the debtor has the incentive to increase the risk of the venture, because he/she will capture the upside of a risky project while nearly the entire downside, such as losses associated with bankruptcy, will fall on the lender.[43] The creditors would like to receive at least a reasonable assurance that the corporation's common shareholders will not be paid before them, in the sense that the shareholders receive money from the corporation, while the creditors are left with an unpaid claim against an insolvent corporation. Without the constraints of the law, the shareholders could theoretically

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[40] *See* Fischel, *Lender Liability*, *supra* note 31, at 135; WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 240-41 (5th ed. 1993); JOSEPH GROSS, HOK HACHAVAROT HACHADASH [The New Companies Law] 331-32 (2d ed. 2000) (Isr). *See also* C.A. 39/80, Berdigo v. D.G.B. 9 Textile Ltd., 35(4) P.D. 197, 222 (S. Ct. Isr.) (Justice Barak explains the significance of the equity cushion stating that because of the shareholders' limited liability, the only security a creditor has its corporate assets. Therefore, it is essential to ensure that the capital of the corporation will remain a basis for the settlement of corporate debts and not be dispersed to the shareholders, if through dividend distribution or another manner).

[41] *See* i*d*.

[42] An example of asset withdrawal is the distribution of funds just issued to the firm in the form of dividends.

[43] KLEIN & COFFEE, *supra* note 40, at 53-62 (an important form of security for the creditor is the assurance that the owner has significant assets at risk. Such an owner will have every incentive to make the business profitable).

reduce their investment risk by draining the corporation of their initial investment (and possibly other corporate assets) and distributing the money back to themselves, after the corporation had taken on debt. Without legal limitations, the shareholders could effectively move themselves up the line for collection, preceding the creditors. This would essentially undermine the principles of the collection chain.

Out of the conflict between the creditors' desire to keep corporate assets from being distributed to shareholders, and the shareholders' desire to do exactly that (despite the existence of outstanding debt or arguably because of it), legal capital provisions have emerged.[44]

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[44] MANNING & HANKS, *supra* note 9, at 16.

## CHAPTER 3

## LEGAL CAPITAL RULES AND THE EQUITY CUSHION

### I. Introduction To The Legal Capital System

Legal capital rules were originally developed to protect third party creditors.[45] These rules were intended to assure creditors that, despite shareholders' limited liability, the corporation would maintain a certain amount of "permanent capital".[46] This permanent capital provides, at least in theory, an equity cushion, thereby protecting creditors by restricting the right of shareholders to withdraw funds from the corporation.

At the same time, Delaware and Israel corporation laws did not generally require corporations to demonstrate a minimum of capital to incorporate.[47] The absence of such requirement is understandable considering the fact that the purpose of the restrictions placed on asset withdrawal, was to minimize the creditors' risk associated with the *failure* of the business.[48]

Understandably, creditors want the corporation to preserve a cushion of protective assets so that claimants who rank junior to them could not draw assets from the

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[45] *Id*. at 12; O'KELLEY & THOMPSON, *supra* note 7, at 567; GROSS, *supra* note 40, at 331.

[46] Fischel, *Lender Liability*, *supra* note 31, at 135; KLEIN & COFFEE, *supra* note 40, at 240-41; GROSS, *supra* note 40, at 331-32; *Berdigo*, 35(4) P.D. at 222 (Justice Barak emphasizes the significance of the equity cushion as a source of creditor security in stating that, because the shareholders enjoy limited liability, the corporation should be required to maintain a minimum permanent capital to secure the interests of the creditors).

[47] YECHIEL BAHAT, THE NEW CORPORATE ISRAELI LAW 438 (1999) (Isr.). I must be noted, however, that with respect to certain industries, such as insurance, banking etc., there are specific requirements of minimum legal capital.

[48] *But see* David Han, *Haluka Leba'alei Menayot Ve Shmirat Hon, He'ara Lehatza'at Hok Hahavarot* [*Distribution to Shareholders and Maintaining the Capital, Comment on the Companies Bill*], A(3) SHA'AREI MISHPAT 313, 314-15 (June 1998) (Isr.) (criticizing the importance of the equity as a protective asset to creditors).

corporation, while their claim is still outstanding and unpaid. Therefore, funds paid to the corporation in consideration for the purchase of shares are to become the permanent capital of the corporation, which cannot be distributed to the shareholders until all claims have been fully paid.

Legal capital doctrines reflect nineteenth century principles.[49] In the landmark case of *Wood v. Dummer*[50]Justice Story noted that,

> During the existence of the corporation [the capital stock] is the sole property of the corporation, and can be applied only according to its charter, that is, as a fund for payment of its debts, upon the security of which it may discount and circulate notes. Why, otherwise, is any capital stock required by our charters? If the stock may, the next day after it is paid in, be withdrawn by the stockholders without payment of the debts of the corporation, why is its amount so studiously provided for, and its payment by the stockholders so diligently required? To me this point appears so plain upon principles of law, as well as common sense, that I cannot be brought into any doubt, that the charters of our banks make the capital stock a trust fund for the payment of all the debts of the corporation. The bill-holders and other creditors have the first claims upon it; and the stockholders have no rights, until all the other creditors are satisfied. They have the full benefit of all the profits made by the establishment, and cannot take any portion of the fund, until all the other claims on it are extinguished. Their rights are not to the capital stock, but to the residuum after all demands on it are paid.

Justice Story construed the shareholders' contributions as a "trust fund" for the payment of all the bank's debts. Nineteenth and early twentieth century trust fund theories were based on the premise that whatever values had originally been paid for shares, should be maintained until such time as all outstanding claims have been paid in full.[51]

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[49] MANNING & HANKS, *supra* note 9, at 20 ("The legal capital scheme contained in our modern corporation codes is the direct product of nineteenth century legal history. Legal capital provisions are comprehensible (to the extent that they are comprehensible at all) only in the context of that history.").

[50] 30 F. Cas. 435 (C.C.D. Me. 1824).

[51] Craig A. Peterson & Norman W. Hawker, *Does Corporate Law Matter? Legal Capital Restrictions on Stock Distributions*, 31 AKRON L. REV. 175, 180 (1997); According to Manning and Hanks

Similarly, Israel's legal capital rules originate from nineteenth century English law. In the case of *Berdigo v. D.G.B.*,[52] Justice Barak noted that the doctrine, which prohibits the reduction in capital, originates from English case law, which set out to assure that creditors have an equity cushion on which they can rely, in face of the shareholders' limited liability.[53] Justice Barak went on to cite from Justice Jessel's opinion, in the 1881 English case of *In re Exchange Banking Co., Flicoft*,[54] where he stated that,

> The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to the company on the faith of the representation that the capital shall be applied only for the purpose of the business. And he has therefore a right to say that the corporation shall keep its capital and not return it to the shareholders.

Because current provisions pertaining distributions are, in both Delaware and Israel, the product of nineteenth century jurisprudence, it is debatable whether they prove suitable in defeating problems arising out of the modern shareholder-creditor conflict.[55]

#### i. Par Value

At the heart of early general corporation laws containing legal capital provisions, was the concept of "par value".[56] Apart from its original purpose,[57] par

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the entire range of legal capital doctrines can be traced to Justice Story's decision in *Wood v. Dummer*. *See* MANNING & HANKS, *supra* note 9, at 30-31.

[52] *Berdigo*, 35(4) P.D. 197.

[53] *See id*. at 222.

[54] [1881] 21 Ch. D. 519, 533 (C.A.).

[55] Legal capital theories have been long criticized as complex, vague and unsuitable.

[56] For the development of the concept par value see O'KELLEY & THOMPSON, *supra* note 7, at 568. Israel's Companies Ordinance, 1983, which preceded the Companies Law, 1999, already recognized the concept of par value from English jurisprudence.

[57] Originally, par value was introduced as a solution to the problem of assuring equitable contribution among shareholders. Par value developed into a legal minimum of what a shareholder ought to pay for his or her stock. MANNING & HANKS, *supra* note 9, at 24.

value has developed as an instrument in furthering the interest of creditors, by securing the shareholders assets within the corporation.

Early corporation codes determined the legal capital of corporations simply by multiplying the number of outstanding shares times the value of those shares. The result was, incidentally, the specified par value of the shares.[58] Early provisions, which sought to restrict asset distributions, further relied on the premise that par value was equal to the purchase price of stocks.[59] During this era, where all shares had par value[60] and most were presumably issued at a price equal to par value, the concept of legal capital had a certain economic significance. Legal capital was conventionally equal to the value created by the issue of stock and became an indicator for the creditors as to the size of the corporation's equity cushion. This scheme was disrupted, however, with the introduction of penny-par stock[61] followed by no-par stock.[62]

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[58] O'KELLEY & THOMPSON, *supra* note 7, at 568 ("[C]orporation law required all shares to have a par value, and custom required that shares be issued for an equivalent price . . . . ").

[59] *Id*.

[60] Melvin Aron Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. MIAMI L. REV. 187, 199 (1983). ("Modern statutes, however, do not require that shares have a par value, and even shares that have a par value may carry a par value much lower than the price at which they are issued."). Israel has only recently facilitated the issuance of stock having no par value. *See* The Companies Law, 1999, 34, S.H. 189.

[61] For instance, a corporation may issue shares having a low par value of less than $1 and yet sell such shares to the public for higher value.

[62] No-Par stocks are stocks that have an arbitrary value assigned to them by the board of directors. They are thus different from par value stocks that have a stated value. *And see* Eisenberg, *supra* note 60, at 199. ("[T]he economic capital generated by the issue of stock may be much greater than the corporation' s legal capital, which has become a mere legal construct determined in a wholly arbitrary manner."); O'KELLEY & THOMPSON, *supra* note 7, at 569:

> [I]n the twentieth century, however, both law and custom changed. Investors came to accept that there was no necessary connection between par value and issue price. This it became common for crop to offer shares to the public at a price far in access of the par value selected for such shares.

**ii. No-Par Stock**

The introduction of no-par stock[63] did not eliminate the concept of legal capital. However, since it was no longer possible to determine the permanent legal capital (the equity cushion) simply by multiplying the number of shares issued times the par value, the corporation's board of directors had to declare its dollar amount. Such dollar number was to be known either as the "stated capital" or the "legal capital" of the corporation. Israeli corporation law continues to refer to legal capital as "stated capital", and Delaware's G.C.L.[64] simply as "capital".

The stated capital represented the stockholder's permanent investment in the corporation and served the same function as par value, insofar as it represented the minimum issue price and the minimum, permanent, amount of the corporation's net assets. At the same time, stated capital provided the corporation with a great deal more flexibility in issuing stocks.

Nowadays, the directors of a Delaware corporation which issues no-par stocks, may determine by resolution and in accordance with section 154 of the Delaware G.C.L.,[65] what part of the consideration received by the corporation for any of the shares

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[63] In Israel no par stocks were introduced only in the 1999 version of the Companies Law in section 34.

[64] Delaware corporation laws are governed by the Delaware General Corporation Laws (hereinafter Delaware G.C.L.).

[65] DEL. CODE ANN. tit. 8 § 154 (2001):

> Any corporation may, by resolution of its board of directors, determine that only a part of the consideration which shall be received by the corporation for any of the shares of its capital stock which it shall issue from time to time shall be capital; but, in case any of the shares issued shall be shares having a par value, the amount of the part of such consideration so determined to be capital shall be in excess of the aggregate par value of the shares issued for such consideration having a par value, unless all the shares issued shall be shares having a par value, in which case the amount of the part of such consideration so determined to be capital need be only equal to the aggregate par value of

of its capital stock will be designated as capital. The directors may later transfer the remaining part of the consideration, with some limitations, outside of the capital account, and under certain circumstances distribute it to the shareholders.[66]

Accordingly, where the actual purchase price exceeds the par value, the paid in capital is separated into stated capital (the aggregate par value of the outstanding shares) and capital surplus (the excess amount).

For example, the shareholders may have paid $100 for each share in the corporation, while the par value of those shares, as determined by the board of directors, was only $40 each. The difference between what the shareholders paid for their shares at the time they were originally issued, and the stated capital represented by those shares, is credited to the capital or paid-in-surplus account.

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> such shares. In each such case the board of directors shall specify in dollars the part of such consideration which shall be capital . . . .
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> . . .
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> **The amount of the consideration so determined to be capital in respect of any shares without par value shall be the stated capital of such shares**. The capital of the corporation may be increased from time to time by resolution of the board of directors directing that a portion of the net assets of the corporation in excess of the amount so determined to be capital be transferred to the capital account. The board of directors may direct that the portion of such net assets so transferred shall be treated as capital in respect of any shares of the corporation of any designated class or classes. The excess, if any, at any given time, of the net assets of the corporation over the amount so determined to be capital shall be surplus. Net assets means the amount by which total assets exceed total liabilities. Capital and surplus are not liabilities for this purpose. (emphasis added)

[66] *See id.* § 244.

Assuming that the corporation has issued 1,000 shares, its balance sheet will look as follows:

| **Assets** | | **Liabilities and Shareholders Equity** | |
|---|---|---|---|
| Cash | 40,000 | Total Liabilities | 10,000 |
| Inventory | 70,000 | Shareholders' Equity | |
| | | Stated Capital | 40,000 |
| | | Capital Surplus/ Paid-in Surplus | 60,000 |
| | | Retained Earnings/ Earned Surplus | - |
| | 110,000 | | 110,000 |

In Israel no-par stocks were only introduced in the 1999 version of the Companies Law.[67] Beforehand, Israeli corporate law recognized par value stocks only. The change was prompted (as it did in the U.S.) by a growing recognition that the strictures that set the historical value of stocks, were rapidly vanishing. The value of stock was no longer tied to the stated/nominal value assigned to it by the shareholders, but rather by real values set by the market.

Nevertheless, even under the new version of the Israeli Companies Law, the legislator proscribed the issuance of par value stocks along with no-par stocks.[68] In sharp contrast, the parallel provision in the Delaware G.C.L., does authorize the issuance of both no-par and par-value stocks, in a single enterprise.[69]

Furthermore, in contrast to Delaware, the introduction of no-par stocks into Israeli corporation law did not broaden the means by which Israeli corporations could engage in asset dispersion. In fact, the introduction of no-par stocks did nothing in this respect.

[67] The Companies Law, 1999, 34 S.H. 189.

[68] The Companies Law provides that the stocks of a corporation may be either par value stocks or no par stocks. A single corporation may not have par stocks and no par stocks along side. *See* id. *See also* BAHAT, *supra* note 47, at 419.

[69] DEL. CODE ANN. tit. 8 § 102(4) (2001).

Israeli corporations are still bound to preserve any and all paid-in share capital.[70] Thus, while Delaware corporations may determine by resolution what part of the consideration will be deemed "capital", for Israeli corporations, the stated capital proper, is the value of its par-value shares and other paid-in share capital, including premiums. [71]

Both jurisdictions stipulate that the stated capital of the corporation is the permanent capital of the corporation.[72] As such, it will be the last asset remaining for distribution if, and once, the corporation exhausts all of its resources to cover its debts.[73]

The Delaware G.C.L., section 154, appears to provide extensive liberty to boards of directors in defining the equity cushion. Any ability the board may have to manipulate this scheme is thought to be limited by the minimum requirements in that section. For the purpose of identifying the equity cushion, the same section 154 provides that, where the corporation issues shares having a par value, the amount designated as capital, may not be less than the aggregate par value of these shares. When read in conjunction with the requirement of section 153 (that shares with par value be sold for at least that amount),[74] section 154 appears to identify the equity cushion for the creditors.

[70] The Companies Law, 1999, 302(b) S.H. 189. *Compare with* DEL. CODE ANN. tit. 8 § 244 (2001).

[71] A "premium" is defined in section 1 of The Companies Law as any consideration received in exchange for shares that exceeds the par value of those shares. The Companies Law, 1999, 1, S.H. 189.

[72] *See* DEL. CODE ANN. tit. 8 § 154 (2001), *and* The Companies Law, 1999, 302 S.H. 189.

[73] Han, *supra* note 48, at 315.

[74] DEL. CODE ANN. tit. 8 § 153(a) (2001) ("Shares of stock with par value may be issued for such consideration, having a value not less than the par value thereof . . . .").

By the late 1960s, dissatisfaction with the entire scheme of legal capital was evident in the U.S.[75] By then, the doctrines of legal capital were wide spread. Most U.S. states had already designed their corporate statutes based on legal capital concepts.[76] Ultimately, increasing criticism is what led the majority of U.S. states to abandon the legal capital doctrines.[77] Oddly enough, both Delaware and Israel have continued to embrace the legal capital model in their statutes.[78]

### II. Distributions And Their Effect On Creditors

A corporation normally distributes funds to its shareholders in one of two ways: by paying a dividend, or by repurchasing/redeeming a portion of its stocks.

The corporation law, of both Delaware and Israel, generally limits the ability of corporations to distribute their assets in a manner that reduces their capital, by applying various tests that essentially center on preserving the legal capital.

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[75] *See* discussion *infra* chapter 4; MANNING & HANKS *supra* note 9, at 39 (arguing that legal capital had changed from an identifiable set of assets contributed by the shareholders to an account with a balance "arbitrarily" set at an amount equal to the par value multiplied by the numbers of shares outstanding. Manning and Hanks write that legal capital "is initially the product of par value -- itself an arbitrary dollar amount printed on the stock certificate and recited in the certificate of incorporation -- multiplied by the number of shares 'outstanding.'").

[76] MODEL BUS. CORP. ACT ANN. § 2, P2 (2d ed. 1971) ("These terms, or similar ones serving the same function, are used in all corporate statutes in the United States today, although they are not always defined.").

[77] ("In 1979, the Revised Model Business Corporation Act ("RMBCA") jettisoned the "outmoded" concepts of par value and stated capital set out in the MBCA in the apparent belief that traditional legal capital doctrines were unduly complex, confusing and misleading.") Peterson & Hawker, *supra* note 51, at 182-83, *quoting* The Committee on Corporate Laws, *Changes in the Model Business Corporation Act -- Amendments to Financial Provisions*, 35 BUS. LAW. 1867 (1980) ("The amendments . . . reflect a complete modernization of all provisions of the Model Act concerning financial matters, including . . . the elimination of the outmoded concepts of stated capital and par value.").

[78] O'KELLEY & THOMPSON, *supra* note 7, at 568,

> The legal capital restrictions based on par value continues to be near universal feature of general corporation codes until 1980, when the ABA Committee on Corporate Laws deleted such provisions from the Model Business Corporation Act (MBCA). Delaware is among the minority of states that continues to have legal capital rules in its corporation codes. The remaining states, many of which follow the MBCA, restrict distributions to shareholders but do not use the legal capital concept.

### i. Dividends From The Point Of View Of Creditors

Dividends are cash payments made by the corporation to its common shareholders pro rata (in the same percentage).[79] From the point of view of the creditors, distribution of dividends lessens the amount of assets in the corporation that potentially guarantees the payment of the debt. Such distributions cause a reduction in the creditors' equity cushion, since once money travels from the corporation to the shareholders, it exits the pool of assets that would have otherwise been attainable by the creditors in payment of their outstanding claims.

The legal rationale behind imposing limitations on corporations' right to affect distributions is twofold. Since the creditor has given up the opportunity to share in the up-side of the business for a promise of a fixed return, and since the shareholders have given up the right to a fixed return for an opportunity to share the proceeds of an up-side, distributions to the shareholders prior to the payment of the debt, and at the expense of the creditor, would unjustly reverse the parties' basic understanding.

### ii. Repurchases From The Point Of View Of Creditors

A corporation's repurchase of its own shares poses many of the same problems posed by dividends. A repurchase is effectively a distribution of assets. The corporation pays through its corporate assets for the return of its own shares.

[79] Shareholders are not entitled to earnings of the corporation. They share in the earnings only once they are declared as dividends. A dividends is "payment to the stockholders as return upon their investment." Penington v. Commonwealth Hotel Constr. Corp., 17 Del. Ch. 394, 155 A. 514 (1931). The Companies Law, 1999 defines dividends as any asset given by the corporation to a shareholder, as a shareholder, in cash or other consideration, including a transfer or a promise to transfer any, without equal value consideration." The Companies Law, 1999, 1, S.H. 189.

If the corporation were to repurchase shares pro rata from each of its shareholders, it will experience the same economic effect as when distributing a dividend. A repurchase that is not pro rata (i.e. where the corporation buys shares only from some shareholders and not from others), may injure not only the creditors but also other shareholders.[80]

While in Delaware share repurchasing is not a new practice, Israeli corporations were prohibited from doing so up until the 1999 Companies Law. By authorizing share repurchases, the legislator has shied away from the long abided English common law rule that companies cannot acquire their own shares.

The prohibition on share repurchasing was established in the English case of *Trevor v. Whitworth* (1887),[81] on the grounds that such an acquisition would amount to an unauthorized reduction of capital to the detriment of creditors.[82] Following this rule, Israeli corporations were prohibited from purchasing their own shares or assisting in the purchase of corporate stock, directly or indirectly.[83] This prohibition did not, however,

[80] For example, a corporation repurchases shares from shareholder X at an above-market price. In doing so, the corporation has depleted corporate assets to the detriment of the creditors and the shareholders who have not had the chance to sell at the higher price. The shareholders and the creditors are now left with a corporation worth less per outstanding share than before.

[81] 12 A.C. 409 (H.L.). The rule was never codified in the Companies Ordinance, 1983.

[82] *Id*.

[83] The Companies Ordinance § 139 (1983); Joseph Gross, *Hahon Haatzmi Bahevra Kecarit Habitahon Lanoshim – Hagana Amitit O Meduma?* (Meah Shana Lehalachat Trevor), 13 IYUNEI MISHPAT 439 (1988) [The Stated Capital of the Corporation as the “Creditors’ Equity Cushion” - A Genuine or an Artificial Protection? (A Hundred Years Since Trevor)]; GROSS, *supra* note 40, at 351; BAHAT, *supra* note 47, at 456 (section 308 provides that shares repurchased by the corporation will not confer upon the corporation any rights while they are held by the corporation. In this manner we avoid the absurd situation where a corporation is controlling itself, and competing against its shareholders in the exercise of its rights. At the same time this facilitates the resale of stock in relatively short periods, stabilizing stock prices.)

affect acquisitions made following a court's approval[84] or the calling in of redeemable preference shares.[85]

Following a more global trend, the new Companies Law permits corporations to repurchase their shares, subject to the general rules governing lawful distributions.[86]

As in the case of dividends, the ultimate effect of a repurchase is a decrease in corporate assets with which the corporation could potentially pay its debts. Therefore, modern statutes generally treat share repurchase in much the same way as they treat dividends.

### III. Legal Limitations On Distributions

#### i. Introduction

The corporation statutes of both Delaware and Israel focus on the impact of wealth distributions on the capital of the corporation. The core objective of the provisions limiting distributions in both statutes, was to protect the creditors of the corporation from improper dissemination of corporate assets.[87] The formula, however, for making wealth distributions to shareholders was, and remains, ostensibly different.

First, while both jurisdictions stipulate that distributions be made out of "profits" and "surpluses", the definitions of these core terms share little resemblance.

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[84] Section 151 of the Companies Ordinance, 1983 enables a reduction of legal capital where adjusting the capital structure would be beneficial to the well being of the business. At present, the court may approve distributions that normally do not qualify under the regular tests set out in the Companies Law. *See* The Companies Law, 1999, 303, S.H. 189 (distributions requiring court approval). For a complete review see BAHAT, *supra* note 47, at 449. Furthermore, section 235 of the Companies Ordinance, 1983 enabled the purchase of minority interests by the company under a court order. This principle was reiterated, with some changes in the Companies Law. *See* The Companies Law 1999, 191, S.H. 189. For a complete review see BAHAT, *supra* note 47, at 449.

[85] Providing that the corporation paid for them using profits or proceeds of a new issue. *See* The Companies Ordinance §§ 141-143 (1983). *And see* The Companies Law, 1999, §§ 312-313 S.H. 189 (subsequent revisions).

[86] The general rule being that distribution be made out of profits and does not render the corporation insolvent. *See* GROSS, *supra* note 40, at 351.

[87] DEL. CODE ANN. tit. 8 § 244 statutory notes (2001); GROSS, *supra* note 40, at 335.

Second, Delaware presents a more flexible and broad approach to distributions. It endorses distributions made from unearned surpluses,[88] some of which are explicitly forbidden under Israeli law,[89] and others that their legitimacy remains unclear.[90]

A recent modification in the 1999 version of the Companies Law, which underscores, perhaps, a more modern approach in Israeli legislation, is the abolishment of the British provision, which subscribed stock repurchases.[91]

Clearly, the new Companies Law takes a different approach to distributions than its English-based predecessor, the 1983 Companies Ordinance. The Companies Ordinance generally prohibited any distribution which had the potential of reducing the corporation's capital, and which was not explicitly authorized. The Companies Law, in sharp contrast, generally authorizes distributions with few exceptions.

Some critics argue that by setting marginal limits on the right to make distributions,[92] the new Companies Law has managed to provide clearer and more uniform rules on lawful distributions.[93] Others will argue that the attempt to lend these rules more clarity was unsuccessful.[94]

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[88] *See* discussion *infra* p. 36.

[89] The Companies Law forbids the distribution of any, and all, funds and premiums paid to the corporation in consideration of stock. Furthermore, distribution must also qualify a second test, namely that the distribution does not prejudice the company's ability to pay its debts. The Companies Law, 1999, 302 S.H. 189.

[90] *See* discussion *infra* p. 37.

[91] *See generally* M. Freeman Durham, *The Companies Act, 1980: Its Effects on British Corporate Law*, 4 J. INTL. L. BUS. 551, 562 (1982) (on the British common law rule prohibiting repurchases).

[92] The Companies Law, 1999, 304(b) S.H. 189.

[93] *See* GROSS, *supra* note 40, at 335.

[94] *See id*.

### ii. Distributions From Surplus

Delaware law permits distributions drawn out of "surplus".[95] The law defines surplus as the corporation's net assets, less the aggregate par value of its shares (i.e., net assets less stated capital).[96]

According to section 244 of the Delaware G.C.L.,[97] a surplus may be created by,

> [T]ransferring (i) some or all of the capital not represented by any particular class of its capital stock; (ii) some or all of the capital represented by issued shares of its par value capital stock, which capital is in excess of the aggregate par value of such shares; or (iii) some of the capital represented by issued shares of its capital stock without par value.

Seeing as the outer limit on distributions is the stated capital,[98] the directors of a Delaware corporation may credit paid-in amounts, exceeding the par value, to a capital surplus account (or paid in surplus account) from which they can subsequently distribute dividends.

Thus, the Delaware G.C.L. focuses on the preservation of the legal capital (presumed to be the creditors' security), making any distribution that does not impair the corporation's capital, lawful.

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[95] DEL. CODE ANN. tit. 8 § 170(a)(2001):

> The directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends upon the shares of its capital stock, or to its members if the corporation is a nonstock corporation, either (1) out of its surplus, as defined in and computed in accordance with §§ 154 and 244 of this title . . . .

[96] *See id*. § 154.
[97] *See* i*d*. § 244 (a)(4).
[98] The consideration paid for the shares, not designated as capital.

This fundamental principle is clearly denoted in Delaware's statutory notes of section 244[99] stating that,

> [The] [r]equirement in this section that no reduction shall be made in the capital stock of a corporation until all its debts are paid means that the capital of the corporation, which is the creditors' security, shall not be impaired. State ex rel. RCA v. Benson (citation omitted).

Furthermore, section 244(b) expressly limits the corporation's ability to affect changes on its capital that might devalue the corporate assets to the detriment of the creditors, stating that "[n]otwithstanding the other provisions of this section, no reduction of capital shall be made or effected unless the assets of the corporation remaining after such reduction shall be sufficient to pay any debts of the corporation for which payment has not been otherwise provided ."

Similarly, Israel's 1999 Companies Law focuses on the effects of distributions on the corporation's capital structure. The Companies Law generally authorizes wealth distributions to shareholders, providing that the stated capital of the corporation, also regarded as the creditors' security,[100] will not be impaired,[101] as well as providing that the distribution will not spin the corporation into insolvency.[102]

In much the same way, the Companies Law allows distributions to be made out of surpluses.[103] However, the Companies Law then defines surplus in a materially different way than its counterpart: as the corporation's net undistributed profits[104] (including accumulated profits from the year of distribution and/or the preceding fiscal year)[105] and

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[99] DEL. CODE ANN. tit. 8 § 244 statutory notes (2001).
[100] Han, *supra* note 48, at 314.
[101] The Companies Bill, explanatory notes, § 345.
[102] The Companies Law, 1999, 302(a) S.H. 189 (regarding the second test).
[103] The Companies Law, 1999, 302(b) S.H. 189.
[104] As defined by acceptable accounting principles.
[105] The Companies Law, 1999, 302(b) S.H. 189.

with the exclusion of any funds and premiums paid in return for stocks.[106] This definition clearly sets aside the stated capital amount, and all paid-in surpluses, as unavailable sources for distribution.

Therefore, in contrast to Delaware which sets the outer limit on distributions on the capital but not on paid in surpluses, the Israeli Companies Law sets aside, as untouchable, the *entire* amount paid by the shareholders for their shares.

### a. Types Of Distributable Surpluses

U.S. legal literature normally cites four basic approaches to limiting corporate distributions to shareholders in U.S. statutes.[107] These four general approaches often appear in combination.

Some states require that distributions be made out of surplus (the excess of net assets over capital),[108] and/or out of the earned surplus (the corporation's accumulated profits).[109] Some states prohibit distribution, which could cause insolvency,[110] and some states have limitations based on current earnings.

U.S. legal commentators clearly draw a line between two central types of statutes: "earned surplus" statutes and "capital surplus" or "surplus" statutes. Earned surplus statutes differ from capital surplus statutes, in that earned surplus statutes disallow

[106] Israel has followed the English Companies Law in defining the legal capital of the corporation. *See* GROSS, *supra* note 40, at 341.

[107] Peterson & Hawker, *supra* note 51, at 175,184; O'KELLEY & THOMPSON, *supra* note 7, at 571-72; Richard O. Kummert, *State Statutory Restrictions on Financial Distributions by Corporations to Shareholders Part II,* 59 WASH. L. REV. 185 (1984).

[108] DEL. CODE ANN. tit. 8 § 154 (2001). *Compare with* The Companies Law, 1999 302(b) S.H. 189. Israel defines surplus more conservatively. The Companies Law, 1999 generally prohibits distributions from unearned surpluses but leaves some unearned surpluses, as revaluation surpluses, in question marks.

[109] *Id*. The surplus test, which is applied in Delaware, is broader than the earned surplus test applied in Israel and includes it.

[110] *See* discussion *infra* p. 78.

distributions from paid-in surplus,[111] from reduction surplus,[112] and from revaluation surplus.[113] Earned surplus statutes are the closest to the approach reflected in the 1999 Companies Law (and its predecessors) with respect to public companies, particularly when combined with the insolvency test, which is equivalent to Israeli common law insolvency.

Under Delaware statute, distributions may be made out of any surplus, earned or unearned,[114] with the basic limitation that it shall not be paid out of capital. This test is less stringent than the earned surplus test, and has earned the Delaware G.C.L. the title of "impairment of capital" statute. In contrast, the Companies Law, which follows a more conservative approach to distributions, clearly makes a distribution of unearned surpluses unlawful.[115]

### b. The Earned Surplus

Earned surpluses, commonly known as retained earnings, are profits accumulated by the corporation during its existence, less any dividends the corporation has paid out since its inception. Both jurisdictions generally allow distributions from the earned surplus account with much ease.[116]

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[111] Amounts paid in exchange for issued stocks, which exceed the par (stated) value of those shares.

[112] The amount by which stated capital can be reduced in some circumstances

[113] The unrealized appreciation on fixed assets.

[114] DEL. CODE ANN. tit. 8 § 170 (2001).

[115] The Companies Law, 1999, 302 S.H. 189. The section also contains a provision allowing nimble dividends (recognizing profit surpluses accumulated from the two years previous to the last financial statement). *See* GROSS, *supra* note 40, at 342.

[116] DEL. CODE ANN. tit. 8 § 170(1) (2001). *See also* DEL. CODE ANN. tit. 8 § 170 statutory notes (2001) (earnings include current and accumulated earnings); The Companies Law, 1999, 302 S.H. 189.

Incidentally, the Companies Law's principal test for distributions is the earned surplus test.[117] Under section 302 of the Act, distributions may be made out of the corporation's accumulated profits,[118] providing that they do not result in the corporation's inability to pay its debts as they become due.[119]

Surplus is defined as net profits appearing in the capital account of the financial statement,[120] computed according to acceptable accounting methods,[121] plus other amounts that are included in the corporation's capital account that are not share capital or share premiums.[122]

In defining the surplus, the Companies Law sets out a two-part test. The first part of the test looks at the past performance of the corporation. It is a historic test that does not necessarily disclose information with regard to the future capabilities of the corporation. The second part of the test looks at the future prospects of the corporation and the likelihood it will be able to fulfill its obligations toward third parties.

Arguably, the second test presents some application difficulties. The test is criticized as being subjective and unreliable. In comparison to the first test, which

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[117] The Companies Law, 1999, 302 S.H. 189. Section 302 also contains a nimble dividends provision; GROSS, *supra* note 40, at 342.

[118] The term "profits" was redefined in the new Companies Law to include nimble dividends. Previously, the Companies Ordinance (Model Regulations, Supp. II) § 98 (1983) stated merely a general rule that dividends must only be paid out of profits. This principle follows the English common law rule stated in *re Exchange*, 21 ch. D. at 533). *See application also* in C.A. 5264/91 Valuation Officer for Large Enterprises v. Ayit Imported Equipment Ltd., 49(3) P.D. 209, 216 (S. Ct. Isr.), C.A. 226/85 Sasa Securities & Investments Co. Ltd. v. Adanim Mortgages & Loans Bank Ltd., 42(1) P.D. 14, 20 (S. Ct. Isr.).

[119] The Companies Law, 1999, 302 S.H. 189.

[120] *Id*.

[121] The categorization of which surpluses are distributable is fundamentally linked to accounting classifications. Such classifications determine which of the amounts that originate from the corporation's net profits should be prescribed to the capital account. The Companies Law reverts to "acceptable accounting methods" in determining the net profits of a corporation. However, a definition of "net profits" is lacking, and the Israeli CPA's Bar has not yet resolved this issue. Nevertheless, the regulations governing the preparation of financial statements provide, generally, that the net profit of a corporation include all income and expenses from any source, be it on-going capital or other. *See* JACOB SAMET, FINANCIAL ACCOUNTING (Vol. 1) 164-71 (1997); GROSS, *supra* note 40, at 342.

[122] The Companies Law, 1999, 302 S.H. 189.

appears objective and more accurate, the future probability that a company will be able to make payment on its debts is subject to estimates and requires careful attention.[123]

Generally, a distribution made in compliance with the requirements of the surplus test is legitimate. However, if an Israeli corporation fails to satisfy the first prong, namely that the distribution be made out of profits, it may still be able to distribute dividends, with the authorization of the court, provided that it satisfies the second prong which is being able to pay its debts as they become due.[124]

### c. Unearned Surplus

The Delaware (impairment of capital) model, does not distinguish between capital surplus and earned surplus.[125] The capital surplus test, being the less restrictive of the two, can be said to incorporate the earned surplus test as well. Moreover, because the capital surplus test focuses on the permanence of the stated capital, it essentially allows distributions from sources that do not impair the stated capital, including distributions from unearned surpluses.[126]

Unearned surpluses may occur in one of the following three ways: paid-in-surplus, revaluation surplus, or reduction surplus.

1. Paid-in-surplus

Paid-in-surplus may occur when the aggregate shareholder contribution exceeds the stated capital represented by shares issued to shareholders. The paid-in-surplus is then

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[123] In the final draft of the 1999 Companies Law the legislator effectively rejected the application of a third test, the liquidity test.

[124] *See* GROSS, *supra* note 40, at 346.

[125] DEL. CODE ANN. tit. 8 § 170 (2001); O'KELLEY & THOMPSON, *supra* note 7, at 572.

[126] Recall that under section 170(a) of the Delaware G.C.L. corporations may pay dividends out of surplus. DEL. CODE ANN. tit. 8 § 170(a) (2001). Surplus is the corporation's net assets less stated capital. *Id* § 154.

the difference between the total paid in share capital and the stated capital represented by the issued shares.

A Delaware corporation may pay out the entire surplus to its shareholders as dividends.[127] In contrast, Israeli law forbids the distribution of share capital, regardless of its designation.[128]

2. Revaluation surplus

Normally, the corporation's assets, as shown on the balance sheet, reflect the historical cost of each individual asset. Through revaluation, the corporation can write-up the value of an asset to its currently higher market value.

Delaware courts and Israeli courts (with less conviction though) have acknowledged that balance sheets are not conclusive indicators of surplus or a lack thereof, and, therefore, allow corporations to revalue their assets.[129]

Delaware law generally allows corporations to revalue assets for the purpose of creating a surplus from which the corporation could subsequently distribute dividends to its shareholders. The directors of a Delaware corporation may further expect some latitude from the courts to depart from the balance sheet in order to calculate surplus,

[127] *Compare*, The Companies Law, 1999, 302(b) S.H. 189, DEL. CODE ANN. tit. 8 § 244 (2001).
[128] The Companies Law, 1999, 302 S.H. 189. *And see* Han, *supra* note 48, at 318.
[129] Klang v. Smith's Food & Drug Ctrs., Inc., 702 A.2d 150, 152 (Del. 1997). *And see id*. at 154:

> We understand that the books of a corporation do not necessarily reflect the current values of its assets and liabilities. Among other factors, unrealized appreciation or depreciation can render book numbers inaccurate. It is unrealistic to hold that a corporation is bound by its balance sheets for purposes of determining compliance with Section 160. Accordingly, we adhere to the principles of *Morris v. Standard Gas & Electric Co.* allowing corporations to revalue properly its assets and liabilities to show a surplus and thus conform to the statute.

In Israel, the viability of revaluations as a source for distribution remains unclear. *See* BAHAT, *supra* note 47, at 443.

given that the evaluation is made "in good faith, on the basis of acceptable data, by methods that they reasonably believe reflect present values, and arrive at a determination of the surplus that is not so far off the mark as to constitute actual or constructive fraud."[130]

Israel's position on this subject remains unclear. The legal community cautiously supports revaluations as a necessary device, though, constantly echoing concerns regarding the association of revaluations with distributions.[131] In addition, Israeli courts have not had the opportunity to resolve the uncertainty surrounding the viability of a 1961 English holding, stating that surpluses resulting from revaluation of fixed assets may be distributed as a dividend or capitalized.[132]

Thus, whether unrealized profits resulting from a revaluation of fixed assets may be so distributed or capitalized, remains undecided.[133]

The hesitance typifying Israeli lawmakers in embracing a broader application of revaluations, reflects a concern that management might misuse this device.

For one thing, when increases in asset value result from short term market value movements, creditors have much to be concerned about. The corporation will have adjusted the value of the asset in its financial books, creating a surplus available for distribution. Removing the surplus from the corporation, while the relevant asset is susceptible to value decreases, could eventually impair the corporations capital.[134]

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[130] Klang, 702 A.2d at 152.

[131] BAHAT, *supra* note 47, at 443. There are no concerns, however, with respect to events that do not cause an export of assets.

[132] Dimbula Valley (Ceylon) Tea Co. v. Laurie, [1961] Ch. 353, 370-374 [Eng.]

[133] BAHAT, *supra* note 47, at 443 (questioning the viability of the rule stipulated in *Dimbula*).

[134] *Id*.

Furthermore, directors generally enjoy enormous discretion in setting distribution policies,[135] and might manipulate the practice of asset revaluation to the detriment of the creditors.[136]

American legal writers have been echoing similar concerns, and yet at least with respect to Delaware, it appears that lawmakers felt confident they would be able to minimize such misuse by other means.

3. Reduction surplus

In addition to revaluation, Delaware, but not Israel, allows the reduction of stated capital for the purpose of creating a surplus. This "artificial" surplus is then available for distribution to the shareholders.

First, the directors of a Delaware corporation may decide, by resolution, to reduce the corporation's stated capital amount.[137] By reducing the par value determinant in the capital account, the directors can cause a somewhat artificial yet legal surplus.[138] This requires, of course, amending the articles of incorporation[139] to which an action by the

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[135] The board of directors is under a duty to evaluate corporate assets on the basis of acceptable data and by standards, which they are entitled to believe reasonably reflect present values. However, the legislators of both Delaware and Israel found it impractical to lay down rigid rules as to what evidence determines proper value, and so misuse of this device may go undetected. Furthermore, factors such as future earnings and the prospects of stocks owned by the corporation may be considered in determining the present value of an asset. This provides directors with additional latitude in ascertaining the current value of corporate assets. *See also* Lawrence A. Cunningham, *Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance*, 84 CORNELL L. REV. 1133, 1181 (1999), *and* GROSS, *supra* note 40, at 342.

[136] *See e.g.*, Klang, 702 A.2d at 153-156 (upholding management's decision to revalue its balance sheet, which made lawful a share repurchase that would have been unlawful without the revaluation under the legal capital rules).

[137] DEL. CODE ANN. tit. 8 § 242(a)(3) (2001).

[138] *See id*. § 242(a)(3) (reducing capital), *and id.* § 244 (distributing/transferring/creating the surplus).

[139] If the corporation's stock is no par to begin with, the stated capital can simply be reduced by a board resolution that is approved by a majority of the stockholders. Where the corporation's shares have par value, then in order to reduce the par value, the corporation will have to amend the articles of incorporation, which also will require shareholder approval.

shareholders is necessary. Shareholders' approval is most likely, however, as the expected benefit is the distribution of the surplus to themselves.

Consistent with Delaware's G.C.L. section 170(a),[140] the directors may declare and pay dividends out of the corporation's surplus. In the event that the corporation has no surplus, the directors may still pay a dividend out of the corporation's net profits. However, since the corporation can ultimately decrease its authorized capital stock by amending its certificate of incorporation,[141] or reducing its capital (by reducing or eliminating the capital represented by retired shares of capital stock),[142] the directors can effectively avoid the restrictions placed on distributions by indirectly increasing its surplus.[143]

The ease with which stated capital could be reclassified as surplus, suggests that legal capital presents no real obstacle to cash dividends.[144] Under these circumstances, stated capital can no longer be a secure source of guarantee for the creditors.

**iii. Nimble dividends**

To the extent that Delaware sanctions the payment of dividends out of unearned surplus as well as out of earned surplus, it operates a more liberal model than does Israel.

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[140] DEL. CODE ANN. tit. 8 § 170(a) (2001).

[141] *Id*. § 242(a)(3) ("[The corporation] may amend its certificate of incorporation . . . [to] decrease its authorized capital stock.").

[142] *Id*. § 244(a)(1) (providing a number of methods by which the board of directors may alter the corporation's capital structure). *And see id*. § 243 (stating that a corporation "may retire any shares of its capital stock that are issued but are not outstanding."), *and* (a corporation "may reduce its capital . . . by reducing or eliminating the capital represented by shares of capital stock which have been retired.") *Id*. § 244(a)(1).

[143] F. John Stark, III et al., "*Marriott Risk": A New Model Covenant to Restrict Transfers of Wealth From Bondholders to Stockholders*, 1994 COLUM. BUS. L. REV. 503, 537 n.121 (1994).

[144] Peterson & Hawker, *supra* note 51, at 199 n.114 (citing Richard O. Kummert, *State Statutory Restrictions on Financial Distributions by Corporations to Shareholders Part I*, 59 WASH. L. REV. 185 (1984)) ("Even in cases where the surplus limitation appears to restrict a corporation's ability to make a distribution, surplus may be created by a change in accounting principles, by the recognition of unrealized appreciation in the value of the corporation' s assets, or by a reduction of stated capital."); LEWIS D.

Recently, however, Israeli lawmakers have taken on a more lax approach to distribution, by writing into the 1999 Companies Law a nimble (quick) dividend provision similar to that of Delaware's.[145]

Nowadays, Israeli corporations may make distributions from current net profits (profits of the fiscal year in which the dividend is declared and/or the preceding fiscal year), unless the distribution is expected to spin the corporation into a financial upset, thus making it unable to pay its debts.[146]

In comparison, while Delaware's G.C.L. contains no insolvency language for distributions, a distribution may nevertheless be set aside as fraudulent.[147]

The Payment of nimble dividends is most useful when the corporation has experienced losses for a number of years, followed by one or two years of earnings. While the current earnings are not sufficient as to cerate a surplus, management may, nevertheless, declare a dividend in order to signal to the shareholders and to the market that the corporation has overcome its difficulties, thus increasing the firm's attractiveness without having to wait for a surplus, that would otherwise be required.[148] The aforementioned is illustrated in the following example.

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SOLOMON ET AL., CORPORATIONS: LAW AND POLICY 260 (3d ed. 1994) ("Concepts of par value provided little protection to creditors because of the ease with which restrictions could be circumvented.").

[145] The Companies Law, 1999, 302(b) S.H. 189; GROSS, *supra* note 40, at 343. *And see also* DEL. CODE ANN. tit. 8 § 170(2) (2001) (providing that where the corporation experiences no surplus, it may still distribute dividends out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year).

[146] The legislator has extended the definition of profits to include current earnings. *See* The Companies Law, 1999, 302(b) S.H. 189. Thus, the insolvency test that applies to general profits (section 302 of the Companies Law) applies with respect to current earnings as well. GROSS, *supra* note 40, at 343. For the insolvency test see discussion infra p. 78.

[147] David Mace Roberts & Rob Pivnick, *Tale of the Corporate Tape: Delaware, Nevada, and Texas*, 52 BAYLOR L. REV. 45, 67-68 (2000).

[148] The Companies Bill, explanatory notes § 348.

In 1998, corporation X issues 1,000 shares, each with a $10 par value, and sells them for $10 each. Corporation X, therefore, has an initial stated capital in the amount of $10,000, and has no capital surplus. In 1999 the directors of corporation X wish to distribute a dividend to the shareholders, after a profitable year that has earned the corporation $5,500. However, the corporation has no earned surplus due to accumulated losses of $7,000, nor does the corporation have a capital surplus from which it could lawfully distribute a dividend. Following is what corporation X's balance sheet looks like:

| **Assets** | | **Liabilities and Shareholders' Equity** | |
|---|---|---|---|
| Cash | 1,000 | Total Liabilities | 1,000 |
| Inventory | 6,500 | Shareholders' Equity | |
| | | Stated Capital | 10,000 |
| | | Capital Surplus/ Paid-in Surplus | - |
| | | Earned Surplus/ Retained Earnings | (1,500) |
| | 7,500 | | 7,500 |

In the absence of a surplus (earned or unearned), the directors of X corporation have their "hands tied". However, the nimble dividends provision enables the directors to declare a dividend up to the amount earned in the previous fiscal year ($5,550) despite the shortage of a surplus. Moreover, corporation X could further distribute dividends up to the amount that the directors estimate the corporation will earn in the current fiscal year.

It is important to note that Delaware has given an expansive interpretation to its nimble dividends provision, by authorizing directors to consider, when evaluating current earnings, factors such as expected future earnings and prospects of stocks owned by the corporation.[149]

[149] DEL. CODE ANN. tit. 8 § 170 statutory notes (2001):

> Factor such as future earnings and prospects and prospects of stocks owned by corporation may be considered in determining present value under this section and future prospects often constitute a most important factor where

For Israel, the nimble dividends provision presents yet another relaxation of the previous tests applied under the Companies Ordinance of 1983. Israel's nimble dividends provision allows the board of directors to pay cash dividends even when the total liabilities of the corporation exceed total assets.[150] The provision presents a sharp move away from the British approach on the subject, which generally prohibits distributions where the corporation has accrued losses. [151]

### iv. Distributions With The Consent Of The Court

One of the common arguments against the conservative approach to limit the sources of distributions to profits, is that it overprotects creditors and unreasonably restricts the corporation. Some critics propose that if the corporation's assets exceed both its debts and its distributions combined, then the corporation should be allowed to proceed with a distribution without having other limitations imposed on it.[152] And indeed, in the final draft of the Companies Bill and in section 303(a) of the Companies Law, the Israeli legislator recognizes the possibility that a corporation will carry out a distribution that does not meet section 302's two-part test for distribution.[153]

Section 303(a) of the Companies Law, provides, in pertinent part, that the court may authorize distributions that do not meet the requirements of the standard test for distribution, if the corporation can demonstrate to the court that there is no reasonable

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> present value is sought to be determined in ascertaining if a corporation may declare dividends. Morris v. Standard Gas & Elec. Co. (citation omitted)

[150] GROSS, *supra* note 40, at 343; MANNING & HANKS *supra* note 9, at 83.

[151] *See* L.C.B. GOWER, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 283 (London, 6th ed. by P.L. Davies, 1997) *and* GROSS, *supra* note 40, at 343 ("No longer may 'nimble dividends' be paid out of profits for the year, ignoring losses for previous years.").

[152] BAHAT, *supra* note 47, at p.455

[153] I.e., that the distribution be made out of profits and will not impair the corporation ability to pay its debts.

concern that the distribution may result in its inability to carry out its present and foreseeable obligations as they become due.

The creditors of a corporation who are seeking the approval of the court, have the opportunity to present their arguments and objections to the distribution.[154]

[154] The Companies Law, 1999, 303(c) S.H. 189.

## CHAPTER 4

## CRITICISM OVER TRADITIONAL LEGAL CAPITAL DOCTRINES

Legal capital restrictions, which were based on par value notions, were nearly a universal feature of general corporation codes in the U.S. until 1980.[155] In 1980, the Committee on Corporate Law of the American Bar Association recognized that legal capital rules were technical and arcane, and completely deleted the financial provisions in the Model Business Corporation Act.[156]

Similar criticism has been echoing in Israel's legal literature for over a decade, yet it has instigated little change. Within the U.S., Delaware remains among the minority of states that continues to apply legal capital rules in its corporation codes.

Legal scholars from both Israel and Delaware have long criticized the legal capital doctrines for failing to achieve their primary objective of protecting the creditors.[157] With the introduction of nominal or no-par value stocks, stated capital no longer represented the collective contributions of the initial shareholders on which creditors arguably relied.

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[155] O'KELLEY & THOMPSON, *supra* note 7, at 568.

[156] Committee on Corporate Laws, Changes in the Model Business Corporation Act -- Amendments to Financial Provisions, *reprinted in* 34 BUS. LAW. 1867 (1979).

[157] *Id*. at 1867 ("It has long been recognized . . . that the pervasive structure in which 'par value' and 'stated capital' are basic to the state corporation statutes does not today serve the original purpose of protecting creditors and senior security holders from payments to junior security holders."); MANNING & HANKS *supra* note 9, at 91 ("[T]he statutory legal capital machinery provides little or no significant protection to creditors of corporations."); Peterson & Hawker, *supra* note 51, at 198 n.111, *citing* Robert C. Art, *Corporate Shares and Distributions in a System Beyond Par: Financial Provisions of Oregon's New Corporation Act*, 24 WILLIAMETTE L. REV. 203, 205 (1988) ("The original goals of the traditional legal capital system . . . were laudable: the protection of investors and creditors."); William H. Ralston, Note, *The 1980 Amendments to the Financial Provisions of the Model Business Corporation Act: A Positive Alternative to the New York Statutory Reform*, 47 ALB. L. REV. 1019, 1025 (1983) ("The intention behind the traditional statutory scheme . . . is to provide a cushion for the protection of creditors."); BAHAT, *supra* note 47, at 456; Ephraim Shmidler & Dan Sheinfeld, *Dinei Shmirat Hahon Behatza'at Hok Hahavarot –*

Par value itself became an arbitrary number susceptible to changes, which did not represent the amount of cash or the value of other assets in the corporation.[158] Furthermore, critics maintain that creditors have better means to protect their interests, from credit reports to the bankruptcy code and bond covenants.[159]

Clearly, legal capital does not provide, nowadays, any real information with regard to the ongoing economic condition of the enterprise.[160] The corporation's legal capital, which has become a mere legal construct, may be much smaller than the economic capital generated by the issue of stock. As a result, statutory legal capital schemes provide no significant protection to creditors.

Nevertheless, do creditors really require the "safeguards" of the legal capital rules? The legal capital rules never prevented the erosion of corporate cash flow, nor did they prevent the incurrence of additional, possibly secured or senior, corporate debt.[161] In

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*"Clalim Optimalim"? [The Rules of Capital Preservation in the Companies Bill – "Optimal Rules"?]*, A(3) SHA'AREI MISHPAT 323 (June 1998) (Isr.).

[158] Manning and Hanks described the legal capital doctrine as having,

> [L]ittle or no relationship to the word 'capital' as the economist, or even the businessman, knows it. Nor is it the block of assets that Justice Story had in mind…Legal capital is entirely a legal invention, highly particular in its meaning, historical in reference, *and not relatable in any way to the ongoing economic condition of the enterprise.* For most purposes it is best thought of simply as a dollar number-a number having certain consequences and derived by specified statutory procedures, but just a number. MANNING & HANKS, *supra* note 9, at 39

[159] Creditors generally use guarantees, secured loans, and stringent default provisions to protect their interests. *See* Peterson & Hawker, *supra* note 51, at 199.

[160] It is argued that the historical relationship between the value of the corporation and its stated capital has been severed once the stated capital became an abstract number obtained by multiplying the number of shares outstanding by the par value assigned to each share. See Eisenberg, *supra* note 60, at 199:

> [L]egal capital was conventionally more or less equal to the economic capital created by the issue of stock. Modern statutes, however, do not require that shares have a par value, and even shares that have a par value may carry a par value much lower than the price at which they are issued.

[161] MANNING & HANKS, *supra* note 9, at 91.

fact, it is often suggested that creditors focus not on the sufficiency of assets remaining upon liquidation of the corporation, but rather, "on the corporation's prospects for remaining a viable on-going concern."[162]

We need to critically consider what the payoffs of this model are, and the extent to which they validate the strain placed on corporate planning and growth.

[162] Ralston, *supra* note 157, at 1027, *cited in* Peterson & Hawker, *supra* note 51, at 200.

## CHAPTER 5

## THE MOTIVES FOR ENGAGING IN CASH DISTRIBUTIONS AND SHARE REPURCHASES

### I. Introduction

Investors and financial analysts often perceive public corporations that engage in the payment of generous dividends, as attractive investments.

For one thing, some regard a dividend payment policy as an indicator of the firm's prospective, as professed by corporate insiders.[163] A growth or a cut in the dividend may be looked upon as signals concerning the financial soundness of the firm, the assumption being, that with no corresponding increases in real earning power, firms are much less likely to be able to increase their dividends over a long period of time.[164]

In addition, corporations that adopt a dividend policy, in effect share-out assets throughout the life of the investment. Many investors prefer receiving a regular stream of cash on their investments without having to wait years for capital appreciation. There is a clear incentive in investing in a dividend paying corporations, especially where there is uncertainty with regard to the firm's ability to increase its earnings. The distribution of wealth back to the investors generally reduces some investment risks.[165]Dividend distributions may reduce risks associated with value decreasing

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[163] *See* GROSS, *supra* note 40, at p. 346; YIZHAK SUARI ET AL., HEBETIM BAHALUKAT DIVIDEND [OBSERVATIONS ON DIVIDEND DISTRIBUTIONS] 27-29 (1999); Joseph Williams, *Efficient Signaling with Dividends, Investment, and Stock Repurchases*, 43 J. FIN. 737 (1988).

[164] *Id*.

[165] GROSS, *supra* note 40, at p.349.

investments made by the corporation, and the risk that management will appropriate corporate assets.

Finally, there is an obvious advantage in such regular cash payments, the alternative being periodically selling portions of holdings which attract transaction costs (brokerage commissions).

The payment of a large special dividend may also be used as a tactical measure to fend-off hostile bidders,[166] by offering equal or greater value, or preempting a likely hostile takeover.[167] In doing so, the corporation could borrow money and use it to pay a large special dividend to its shareholders. After the dividend, the firm will be highly leveraged.

In addition to dividend distributions, there are other methods of distributing cash to the public shareholders, including share repurchases from shareholders. Share repurchases, or buybacks, are, "distributions of cash by a firm in exchange for a portion of its outstanding common stock."[168]

Buybacks are financial devices which have similar purposes as stock issuances, but opposite effects. A corporation requiring additional capital may respond by issuing stock. Buybacks are like reverse stock issuances in the sense that when the corporation experiences a surplus cash flow, or has earnings which exceed those needed to finance positive net present value investment opportunities,[169] it may announce a buyback.[170]

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[166] GILSON & BLACK, *supra* note 24, at 402.

[167] The term "takeover" describes the acquisition of control of a business enterprise. *See* The Dictionary of Financial Risk Management, *available at* http://riskinstitute.ch/

[168] *See* F.H. Buckley, *When the Medium Is the Message: Corporate Buybacks as Signals*, 65 IND. L.J. 493 (1990).

[169] GILSON & BLACK, *supra* note 24.

[170] Buckley, *supra* note 168, at 494.

Generally, a corporation can repurchase its own shares either through an open market repurchase, a tender offer repurchase, or a private repurchase.[171] Although it is reported that most of the cash distributed by public corporations to their shareholders still takes the form of dividends, an increasingly large proportion of this cash is distributed by repurchasing shares from public shareholders.[172]

Common explanations for the growing popularity of share repurchases relate to their tax efficiencies over the tax treatment of dividends,[173] and their effect on

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[171] Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 421 (2000) (hereinafter Fried, *Insider Signaling)* (in tender offer repurchases a corporation will offer to buy back its own stock, usually at a premium over the market price); Buckley, *supra* note 168, at 494-95 (on types of repurchases):

> Self-tenders must be made in accordance with regulations similar to those governing ordinary tender offers, including the solicitation of "all shareholders," with proration if an offer is oversubscribed. Open market and private repurchases are not subject to these regulations, because they may be structured so as not to constitute "tender offers" under the Williams Act. Open market repurchases are made on secondary markets at the then-prevailing price, while private or "targeted" repurchases are made from a few sellers at a price which usually exceeds market value.

[172] Fried, *Insider Signaling, supra* note 171, at 427.

[173] Share repurchases are generally more tax efficient than dividends for the following reasons. First, the funds allotted to dividend payments will effectively be taxed twice where the recipient is an individual. The corporation will pay income tax and the recipient individual will then pay federal taxes on the dividend. Furthermore, the recipient will have to incur reinvestment costs instead of having had the corporation invest the funds internally from the outset. While dividends are taxable for many taxpayers, cash, paid in a stock repurchase, is not taxed to the extent that it represents a return of the initial investment (basis). *See* Fried, *Insider Signaling, supra* note 171, at 427 n.26. However, it is important to note that many dividend recipients are either not taxed at all, or are lightly taxed. For example, pension funds, which hold a significant portion of corporate stock, are completely tax-exempt. Similarly, inter-company dividends are only lightly taxed in the owner's hands. Thus, X corporation, which owns stock in Y corporation, would be subject to higher capital gain tax if X was to sell off its stock-holdings in Y, after Y has reinvested all of its dividends and experienced as a result an increases in stock value. For share repurchases to avoid the tax implications that dividends experience (and be considered superior) they must not be essentially equivalent to a dividend. That is, they cannot be pro rata. *See* 26 U.S.C. § 302(b) (2001) ("Redemptions treated as exchanges. (1) Redemptions not equivalent to dividends. Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend. (2) Substantially disproportionate redemption of stock."). Thus, any payment in excess of the basis (amount representing the initial investment in that stock) will be taxed as capital gain. In many cases the tax rates on capital gain will be lower than the ordinary tax rate imposed on dividends. *See* Fried, *Insider Signaling, supra* note 171, at 427 n.26.

management stock options.[174] There are, however, additional theories why a corporation may wish to repurchase its common stock. For one, the corporation may have excess cash that it cannot productively reinvest in its own business. It is suggested that under such circumstances, returning this cash to the shareholders by repurchasing their shares is more sensible.[175] Other financial strategies may include objectives such as raising earnings per share, rewarding non-selling shareholders of undervalued stock, and manipulating stock value.

It is widely argued that increasing the firm's leverage will consequently reduce agency costs, by improving managerial incentives.[176] Borrowing funds for the purpose of carrying out a stock repurchase program, or paying a special dividend, may help in reducing agency costs. At the same time, it must be noted that increasing the firm's leverage is synonymous with transferring value from creditors.[177]

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[174] *See* Fried, *Insider Signaling*, *supra* note 171, at 427 n.27 for the premise that tax repurchases are less likely (than dividends) to downgrade the value of managers' stock options:

> Cash dividends reduce the per-share value of the firm, which in turn lowers the market price of the stock. The value of stock options depends on the difference between the exercise price (the price at which the manager may purchase the stock) and the market price (the price at which the manager may sell the purchased stock). Thus, unless the options' exercise price is lowered to take dividends into account, the effect of dividends will be to reduce the options' value. Repurchases do not reduce the per-share value of the firm (and hence the stock price) to the extent the outflow of value is matched by a corresponding reduction in the number of outstanding shares.

Although share repurchases may be more tax efficient than dividends and have less of an adverse impact on the value of managers' stock options, there are countervailing considerations that may make dividends a more attractive mechanism for distributing cash in some cases. Other considerations may make dividends a more attractive means for distributing cash in some cases. Dividends are a less expensive method for corporations to distribute cash when the stock is overvalued. *See id*. at 427 n.28, *and* Bhagwan Chowdhry & Vikram Nanda, *Repurchase Premia as a Reason for Dividends: A Dynamic Model of Corporate Payout Policies*, 7 REV. FIN. STUD. 321 (1994). Dividends may reduce the risk of shareholder expropriation by insiders. *See* GILSON & BLACK, *supra* note 24.

[175] On the excess cash (free cash) theory see Fried, *Insider Signaling*, *supra* note 171, at 438.

[176] On the agency cost theory see, generally, Fried, *Insider Signaling, supra* note 171, at 439-40. *See also* text *infra* p. 53.

[177] On the creditor expropriation theory see Fried, *Insider Signaling, supra* note 171, at 440.

Stock repurchase programs, as special dividend programs, are also a most popular device for defeating an unwanted takeover bid,[178] or simply as a means of reducing the issuer's vulnerability to unsolicited acquisitions.[179]

Finally, a corporation may decide to repurchase (or redeem) its own shares for general business reasons, including reducing aggregate dividends and other shareholder servicing costs, satisfying stock options without diluting earnings per share, fulfilling buy-sell agreements on the death of a shareholder, or eliminating fractional shares.[180]

## II. Leveraged Recapitalizations

Corporations undergoing leveraged recapitalization, will sometimes borrow funds and use them to either pay a large special dividend to the shareholders, or to repurchase a large fraction of their outstanding shares.[181] As a result, such corporations will have increased their leverage level, and will now be obligated to repay the cost of their new debt. Their capital structure will remain unchanged where they undergo recapitalization followed by a dividend payout, whereas if the funds are used to repurchase shares, then their remaining equity will be divided into fewer outstanding shares.

Gilson and Black report that most leveraged recapitalizations are defensive, and are entered into as a way to defeat a hostile takeover bid.[182] In essence, leveraging a corporation through restructuring, reduces the firm's attractiveness to a hostile bidder by depleting corporate assets. The leverage proceeds leave the corporation to the hands of its

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[178] On stock repurchase as a defensive measure see GILSON & BLACK, *supra* note 24, at 761.

[179] On stock repurchase as a preventive measure see id.

[180] *Allen Resnick, The Deductibility Of Stock Redemption Expenses And The Corporate Survival Doctrine*, 58 S. CAL. L. REV. 895, 895 n.2 (1985).

[181] Often management will use the dividend money to purchase more stock in order to increase management's ownership percentage.

[182] GILSON & BLACK, *supra* note 24, at 402.

shareholders, increasing the short-term value of their investments while decreasing the value of the corporation itself.

Nonetheless, the benefits of recapitalization have been recognized, apart from solely being a defensive tactic. The agency cost theory, proposes that repurchases and special dividend distributions might reduce agency costs by improving managerial incentives.

First, where the repurchase or dividend distribution is funded with new debt, the obligation to make (additional) recurring interest payments may encourage managers to focus on performance and revenues, cutting costs and increasing efficiency.[183]

Second, to the extent that buybacks increase management's proportional ownership of the corporation (by reducing the number of shares outstanding), the repurchase may serve as a performance incentive, encouraging management to take only value increasing actions as they will share a better fraction of the value they create. Otherwise, management can be expected, unless constrained, to maximize their own welfare rather than the shareholders'.[184]

[183] Buckley, *supra* note 168, at 520-22 (once new debt is issued, the new creditors might be better suited for monitoring managers than the existing shareholders); Fried, *Insider Signaling, supra* note 171, at 439; Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence***,** *in* Knights, Raiders & Targets: The Impact of the Hostile Takeover, 321-22 (John Coffee et al. eds., 1988) (applying the free cash flow theory to mergers, Jensen identifies a similar effect. Jensen theorizes that managers have incentives to retain free cash flow rather than distributing it to shareholders, and to use the free cash flow to make negative net present value investments).

[184] *See* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (while management acts as agents of the shareholders and should, presumably, act in the shareholders' best interest, it can be expected to promote its own inertest in the absence of effective monitoring. Thus, it is in the owners' interest to incur monitoring costs. It will also be in the owners' interest to provide profit-sharing incentives to reduce the divergence of interest between management and the shareholders).

Gilson and Black describe the ideal candidate for a leveraged recapitalization as a mature, slowly growing, company, having predictable cash flows and generating more cash than it can profitably reinvest in its business.[185]

Michael Jensen, and other writers, maintain that in cash-rich, low growth or declining sectors, the pressure on management to waste cash flow internally and make investments in unsound projects, is often irresistible.[186] Jensen stresses the importance of leverage as an instrument in reducing the agency costs associated with free cash flow.[187] The benefits of such capital structure transformation exceed, in Jensen's view, the traditionally recognized benefits of a publicly held corporation (diversifying and customizing risks with diversified portfolios of public investors that would otherwise be borne by the owners, and facilitating the creation of a liquid market for exchanging risk, i.e., causing a decrease in the cost of capital).[188] Jensen concludes that, "[t]he genius of the new organizations is that they eliminate much of the loss created by the conflicts between owners and managers, without eliminating the vital functions of risk diversification and liquidity once performed exclusively by the public equity markets."[189]

Michael Jensen suggests, replacing the public corporation structure (funded by public equity) with public and private debt structure as a major source of capital, where the corporation's long-term growth is slow, where internally generated funds exceed the opportunities to invest in them profitably, or where downsizing is the most productive

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[185] GILSON & BLACK, *supra* note 24, at 403 (as opposed to a fast growing company which is unsuitable because it needs all the available cash it has to reinvest in its business).

[186] Michael C. Jensen, *Eclipse of the Public Corporation*, 67 HARV. BUS. REV. 61 (Sept.-Oct. 1989) (hereinafter Jensen, *Eclipse of the Public Corporation*).

[187] Jensen maintains that a decline of publicly held, equity funded corporations, and the increase of closely held, debt-funded corporations may reduce the agency costs associated with free cash flow. *See id.*

[188] *See* Jensen, *Eclipse of the Public Corporation*, *supra* note 186, *reprinted in* GILSON & BLACK, *supra* note 24, at 407.

[189] *See* id.

long-term strategy.[190] Jensen claims that the survival of the public corporation may depend on its ability to centralize ownership control, using leverage to avoid the consequences of the conflict of interest between those who bear the risk (shareholders and creditors) and those who manage it (executives).[191]

Jensen treats debt as a mechanism superior to discretionary dividends in its ability to force management to pay out future cash flows rather than spend it on, "empire-building projects with low or negative returns, bloated staffs, indulgent perquisites, and organizational inefficiencies."[192] Due to intensified monitoring which follows an increase in leverage, management has an incentive to perform well and avoid wasting assets, because they are more vulnerable to displacement.

Finally, aside from borrowing funds for the purpose of distributing dividends, and repurchasing shares for the purpose of reducing the waste of free cash flow, Jensen recognizes the benefits of having a highly leveraged firm at the stage of insolvency or near insolvency. Jensen argues that the costs of becoming insolvent are likely to be significantly smaller where the firm is highly leveraged. He further argues that highly

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[190] *See* id. (Jensen's debt finance versus stock finance hypothesis incorporates theories on the role of debt in reducing managerial agency costs and the conflicts of interest between managers and shareholders, and bondholders and shareholders).

[191] For criticism over Jensen's approach see Alfred Rappaport, *The Staying Power of the Public Corporation*, 68 HARV. BUS. REV. 96 (Jan.-Feb. 1990) (leveraged buyouts are inherently transitory; high debt levels and concentrated ownership impose costs in the form of reduced managerial flexibility in responding to competition and change); Steven N. Kaplan, *The Staying Power of Leveraged Buyouts*, 29 J. FIN. ECON. 287, 290 (1991) (leveraged buyouts are not permanent, but are not short-lived); Norm Alster, *One Man's Poison .... (Who Benefits from Leveraged Buyouts)*, FORBES, Oct. 16, 1989), *discussed in* Kimberly D. Krawiec, *Derivatives, Corporate Hedging, and Shareholder Wealth: Modigliani-Miller Forty Years Later*, 1998 U. ILL. L. REV. 1039 (high debt makes firms less flexible. This can lead to long-run costs where leveraged firms are unable to compete and expand as aggressively as their non-leveraged rivals. The result, major market share).

[192] Jensen, *Eclipse of the Public Corporation*, *supra* note 186, *reprinted in* GILSON & BLACK, *supra* note 24, at 407.

leveraged firms rarely enter formal bankruptcy, because they are reorganized quickly at lower costs.[193]

### III. The Excess Cash Theory

The excess cash theory is a leading explanation for non-defensive repurchases.[194] According to the excess cash theory, corporate insiders have a propensity to plow-back too much of the cash generated by their firms because they have an inclination to spend it on power building, prestige, and compensation, the last two of which normally increase with the size of the firm.[195] By repurchasing shares or distributing dividends, the firm returns these unneeded funds to the shareholders, and management's ability to waste free cash in this manner is reduced.[196]

### IV. The Signaling Explanation

While many accounting and legal scholars advocate that dividend distributions and stock repurchases are, essentially, cosmetic maneuvers that hardly reflect income concentration or balance sheet valuation, more than sixty years of studies reveal that shareholders generally react positively to stock distribution announcements.[197]

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[193] *See id*. at 413-14.

[194] *See* Rene M. Stulz, *Managerial Discretion and Optimal Financing Policies*, 26 J. FIN. ECON. 3 (1990) (use of debt to reduce free cash flow and managerial agency costs); Tom Nohel & Vefa Tarhan, *Share Repurchases and Firm Performance: New Evidence on the Agency Costs of Free Cash Flow*, 49 J. FIN. ECON. 187 (1998). *But see* Keith M. Howe et al., *One-Time Cash Flow Announcements and Free Cash-Flow Theory: Share Repurchases and Special Dividends*, 47 J. FIN. 1963, 1965 (1992) (finding no empirical support for free cash flow benefits of share repurchasing). *Compare*, Steven B. Perfect et al., *Self-Tender Offers: The Effects of Free Cash Flow, Cash Flow Signaling, and the Measurement of Tobin's q*, 19 J. BANKING & FIN. 1005, 1006-07 (1995) (criticizing Howe and finding some empirical support for the free cash flow benefits using a different approach).

[195] Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporation Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

[196] Fried, *Insider Signaling*, *supra* note 171, at 438.

[197] Peterson & Hawker, *supra* note 51, at 207; Eugene F. Fama, Lawrence Fisher et al., *The Adjustment of Stock Prices to New Information*, 10 INT' LECON. REV. 1, 16 (1969) (empirical evidence suggests that shareholders interpret distributions, stock dividends and stock splits as information about the financial disposition and prospects of the firm.); C. Austin Barker, *Evaluation of Stock Dividends*, HARV. BUS. REV. (July. 1958), *cited in* Peterson & Hawker, *supra* note 51, at 206 n.160.

Managers often have inside information[198] that is not reflected in the stock price.[199] This information may indicate that the stock is under priced or overpriced. In order to disclose this information to shareholders, management may wish to communicate it to shareholders through a general announcement as a dividend distribution or stock repurchase. The suggested theory is that managers may use dividend distributions or share repurchases to convey information about the firm value.[200] Through stock distribution announcements, management will either look to signal the permanence of past earnings or the increased potential of future earnings.[201] Indeed, current studies offer signaling explanations for observed price responses to such announcements.[202]

According to the signaling theory, for a signal that the stocks are under priced to be credible, managers must act in a way that will impose substantial costs on them if the stock is not actually under priced.[203] A tender offer repurchase[204] facilitates the sending of such a credible signal, particularly when offering to repurchase shares at a premium

[198] "Inside information" is nonpublic information available to insiders by virtue of their positions within the corporation, including information relating to the value of the firm. *See* Buckley, *supra* note 168, at 528, 536-37 (1990) (the nature and relevance of "soft" information).

[199] *See id*. at 528, 536 (insiders have better information than public shareholders); Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 317-29 (1998) (insiders have inside information not reflected in the stock price).

[200] Shmidler & Sheinfeld, *supra* note 157, at 326.

[201] Maureen McNichols & Ajay Dravid, *Stock Dividends, Stock Splits, and Signaling*, 45 J. FIN. 857, 871 (1990) (managers incorporate private information about future earnings in setting the split factor in a stock split); Paul Asquith et al., *Earnings and Stock Splits*, 64 ACCT. REV. 387 (1989).

[202] Studies supporting a signaling theory as an explanation for investor reaction to stock distribution announcement include Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699, 708-09 (1981) (hereinafter Fischel, *Dividend Policy*) (changes in dividend policy can send signals to investors about the firm's prospects, thereby affecting share prices); Michael J. Brennan & Patricia J. Hughes, *Stock Prices and the Supply of Information*, 46 J. FIN. 1665 (1991); McNichols & Dravid, *supra* note 201; Fried, *Insider Signaling, supra* note 171; Stephen A. Ross, *The Determination of Financial Structure: The Incentive Signaling Approach*, 8 BELL J. ECON. 23 (1977); Sudipto Bhattacharya**,** *Imperfect Information, Dividend Policy and 'The Bird in the Hand' Fallacy*, 10 BELL J. ECON. 259 (1979).

[203] Fried, *Insider Signaling, supra* note 171, at 442.

[204] In a tender offer the corporation makes a time-limited offer to repurchase a specified amount of stock.

over the market price.[205] By committing not to tender their shares, insiders can credibly signal that the stock value is higher than the repurchase price.[206]

The signaling theory can also explain why managers might prefer buying back stocks over distributing dividends. A dividend does not confer information over insiders' beliefs as effectively and precisely as a tender offer repurchase, because it does not compel insiders to purchase shares at a particular price.[207] However, while dividend distributions do not signal much information about the value of the stock relative to the market price, a dividend policy may be interpreted by investors as managers' forecasts of future earnings changes.[208]

There is some question about why and to what extent dividend policy affects security prices. The signaling power of insiders may explain the differing market reactions to the announcement of dividend initiations.[209] The pure model of the efficient market hypothesis[210] posits that in a world of perfect information, dividend policy should

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[205] For the advantages of tender offers over open market repurchases see Fried, *Insider Signaling*, *supra* note 171, at 443:

> The signaling theory can explain why a firm would conduct an RTO [repurchase tender offer] rather than an OMR [open market repurchase]. In particular, an OMR does not send as precise a signal as an RTO . . . . An RTO enables insiders to better demonstrate the extent to which the stock is under priced by allowing them to set the offer price equal or closer to its actual value.

[206] *Id*. at 442. S*ee also id*. at 443 (the larger the repurchase amount and the higher the percentage of insider ownership the more credible is the signal.).

[207] *See* id. at 443.

[208] Paul M. Healy & Krishna G. Palepu, *Earnings Information Conveyed by Dividend Initiations and Omissions*, 21 J FIN. ECON. 149 (1988); Merton H. Miller & Kevin Rock, *Dividend Policy Under Asymmetric Information*, 40 J. FIN 1031 (1985).

[209] Benjamin Graham discusses the historical primacy of dividends in investment decisions through the dividend theory of stock valuation. The theory posits that dividend policy is the single largest determinant of share value**.** *See* BENJAMIN GRAHAM ET AL., SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES, 480-82 (4th ed. 1962).

[210] On the efficient market hypothesis see generally O'KELLEY & THOMPSON, *supra* note 7, at 169-74.

have no effect on the value of a firm or the market value of its stock.[211] However, in the real world, where information regarding stock value is disseminated to the general public asymmetrically, dividends may serve as a signaling function.[212]

Generally, dividend initiations or increases are interpreted as mirroring expected earnings increases and firm value.[213] Therefore, unexpected increases or decreases in dividend policy are thought to affect stock prices. Furthermore, analysts commonly tie the effects of dividend policy to the availability, or lack thereof, of positive net present value investment opportunities within the firm.[214]

It is further argued that dividends are a superior signaling source because, unlike other forms of information about a firm's prospects, changes in dividend policy are more reliable. The case made is that while financial accounting and projections of management are subject to a good deal of manipulation and bias, dividend changes require a company "to put its money where its mouth is."[215]

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[211] *See* Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth and the Valuation of Shares*, 34 J. BUS. 411 (1961) (discussing the effects of a firm's dividend policy on the current price of its shares).

[212] *See* Bhattacharya, *supra* note 202 (cash dividends function as signal of expected cash flows); Miller & Rock, *supra* note 208.

[213] *But see* W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE 303-06 (2d ed. 1986) (makes the case that the total value of a firm is determined by investment policy, not dividend policy); Fischel, *Dividend Policy*, *supra* note 202, at 701 ("Because a firm's dividend policy . . . is simply a decision as to how the firm's real value should be packaged for distribution, it should have no effect on share prices."); Victor A. Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85, 86-87 (1980) (suggests that dividend policy is merely the residual of investment policy and, as such, irrelevant to share prices).

[214] *See* Kose John & Larry H. P. Lang, *Insider Trading Around Dividend Announcements: Theory and Evidence*, 46 J. FIN. 1361, 1367 (1991) (increased dividends may convey negative information). Although market professionals generally agree that dividends are important to shareholders, others defend Professors Miller and Modigliani's irrelevance theory. Miller and Modigliani argue that if a company can reinvest free cash at a return equal to the firm's current return, then the shareholders should be indifferent to whether the company pays a dividend or reinvests the available cash. *See* Merton Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares,* 34 J. BUS. 411 (1961). For further discussion on the irrelevance theory see Richard A. Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 CALIF. L. REV. 1055, 1064 n.25 (1992).

[215] Booth, *supra* note 214, at 1067. *And see id*. at 1067 (any company can claim financial health, but a company that is really doing better ought to be able to extract more cash and pay it out). *And see also*

In much the same way, a reduction in dividends, namely a failure to maintain the payout rate, is a negative signal that the company is facing financial difficulties. This could explain why corporate boards are generally reluctant to adjusted dividends downward due to the potentially negative impact on the company's stock price.[216] However, because the market does not react favorably to dividend cuts, the corporate board will typically try to avoid them and, at times, contrary to all financial sense.

A repurchase program performs a function similar to that performed by the payment of dividends, though interferes less with the parties' investment preferences. The corporation can fine-tune its policy, buying at one time and not at another, whereas with a dividend policy, the corporation is almost locked into a periodically increasing or at least constant amount.

#### i. Undervalued Stock

Corporate managers often engage in stock repurchases when the market temporarily undervalues the corporation's stock.[217] Non-selling shareholders are inevitably rewarded, as they will get a better piece of the undervalued pie at no additional cash outlay.

Often, corporations launch stock repurchase programs with the announced intention of increasing the price of their equity securities. Such repurchases are premised on the belief that a reduction in the supply of outstanding stock will lead to price increases of the remaining (non tendering) shares. A growing number of scholars have

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*id*. at 1075 ("Shareholders are inconvenienced by irregular cash flows and corporate managers can without great difficulty adjust their cash resources so as to pay steady dividends. Thus, dividends should be not only generous but stable.").

[216] Norris, *Market Place: On Dividends, Some Fresh Hope*, WALL ST. J., Jul. 2, 1991, at D8, col. 2, *cited in* Booth, *supra* note 214, at 1067 n.33.

[217] Shmidler & Sheinfeld, *supra* note 157, at 326; BAHAT, *supra* note 47, at 352.

studied this phenomenon over the years, and contrary to traditional notions,[218] have presented the view that stock prices are much like other commodities in that their price is sensitive to varying levels of supply and demand.[219]

#### ii. Raising Earnings Per Share

Another rationale in support of share repurchasing is that it may instigate a rise in the earnings per share.[220] Earnings per share are probably the most important single determinant of share prices.[221] A buyer of common stock is often more concerned with the earnings power of a stock than with its dividend. This is because earnings per share usually influence the stock market prices. When the earnings per share ratio rises, share value is likely to improve as well, depending on how cheap the stock is, relative to its earning power.

Scholars suggest that the stock market uses earnings as signals to make a rational forecast of firm value.[222] Since higher earnings today are likely to be correlated with

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[218] That the shareholder supply curve for publicly traded stock is flat.

[219] Empirical studies have made it increasingly clear that the shareholder supply curve for publicly traded stock is not flat, but rather upward sloping. That is, in order to purchase more shares, one must pay a higher price because shareholders have different reservation values for the same stock. The market price therefore reflects the value of the lowest-valuing or marginal shareholder and "[s]hareholders with higher reservation values are not willing to sell at the market price. Those with lower reservation values will already have sold their shares." Fried, *Insider Signaling, supra* note 171, at 435; Richard A. Booth, *The Efficient Market Portfolio Theory and the Downward Sloping Demand Hypothesis*, 68 N.Y.U. L. REV. 1187, 1188 n.3 (1993); Anise C. Wallace, *Takeovers and Buybacks Propping Up Stock Prices*, N.Y. TIMES, June 20, 1988, at D1 (studying stock repurchases and their effects on share prices); Laurie Simon Bagwell, *Dutch Auction Repurchases: An Analysis of Shareholder Heterogeneity*, 47 J. FIN. 7, 97 (1992); Larry Y. Dann, *Common Stock Repurchases: An Analysis of Returns to Bondholders and Stockholders*, 9 J. FIN. ECON. 113, 136-37 (1981) (self-tender offers tend to involve larger amounts and seem motivated by low stock prices. Stock repurchases tend to increase share prices).

[220] Earnings per share (EPS) represent the share of the earnings that each stock is entitled to (net income divided by common shares outstanding). EPS are an important indicator in assessing stock value.

[221] For instance, the most widely used indicator of whether a stock is overvalued or undervalued is the price/earnings (P/E) ratio, which relates share price to earnings per share.

[222] Neil C. Rifkind, Note, *Should Uninformed Shareholders Be a Threat Justifying Defensive Action by Target Directors in Delaware?: "Just Say No" After Moore v. Wallace,* 78 B.U.L. REV. 105, 143 (1998).

higher earnings in the future, managers may attempt to manipulate these signals, inflating earnings to raise forecasted value.[223]

For a repurchase strategy to have the effect of raising earnings per share for the remaining shareholders, it must provide better share value than that realized by reinvesting the repurchase money. For example, suppose that X corporation is a mature business in a mature industry that by reinvesting its capital could realize an after-tax return of 7%. If X was to repurchase its shares for eight times earnings, then every $1 spent on the repurchase of shares will make 12.5 cents of earnings to the non-selling shareholders. As a result X's earnings per share will be higher than if the earnings were plowed back.

### V. The Bird-In-The-Hand Theory

It has been further suggested that shareholders prefer dividends to the retention of funds by a corporation, because dividends are a "bird in the hand."[224] The theory is that shareholders consider it safer to take the cash dividend than to leave it up to the corporation to invest the excess funds internally[225].

Market professionals and legal scholars often criticize this theory for failing to acknowledge that investors have already weighted this risk factor.[226] These scholars propose that market prices already include what investors consider as risk elements, thus making the bird-in-the-hand theory redundant.

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[223] *See* id. at 143. *But see* id. at 143 n.247 (arguing that market participants already take into account earnings inflation).
[224] Booth, *supra* note 214, at 1065.
[225] Fischel, *Dividend Policy*, *supra* note 202, at 702-3.
[226] Booth, *supra* note 214, at 1065.

## VI. The Takeover Defense Theory

Some central features of corporate planning include stock acquisitions as preventive and defensive measures.

Stock acquisitions are sometime made as a preventive measure, to reduce issuer vulnerability to unsolicited acquisition bids.[227] Target corporations[228] sometimes employ defensive tactics in an effort to thwart a pending hostile bid. Increasingly, target boards have resorted to repurchase programs as means of defeating hostile bids, either through enhancing an existing control position of a loyal shareholder or raising the bidder's cost.[229]

Where a strong control block already exists, repurchasing public stock will have the effect of increasing the percentage ownership of the non-selling control group.[230] Enhancing the control of a loyal party (management or management loyalist who are unlikely to tender to the bidder) increases the probability that the bid will ultimately fail.

In the absence of a strong control block, the issuer's self tender, standing alone, will not defeat a hostile bid but in effect will assist the hostile bidder. By repurchasing shares, the issuer will have reduced the amount of shares the bidder must acquire to realize control (because it reduced its outstanding capitalization).[231]

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[227] Shmidler & Sheinfeld, *supra* note 157, at 326.

[228] A company that is the object of a takeover attempt is a target company. The Dictionary of Financial Risk Management, *available at* http://riskinstitute.ch/.

[229] GILSON & BLACK, *supra* note 24, at 762, *citing* Nathan & Sobel, *Corporate Stock Repurchases in the Context of Unsolicited Takeover Bids*, 35 BUS. LAW. 1545 (1980).

[230] *See* id. at 762 ("[R]epurchases may increase the percentage of shares held by management or another friendly group and effectively force the unsolicited bidder to acquire a supermajority of the remaining shares to succeed."); Louis P. Friedman, Note, *Defensive Stock Repurchase Programs: Tender Offers in Need of Regulation*, 38 STAN. L. REV. 535 (1986).

[231] Nathan & Sobel, *supra* note 229; Friedman, *supra* note 230, at 562:

> Stock repurchases could facilitate a hostile takeover, since they would merely reduce the number of shares a third party would need to effectuate its design. The success of the defensive-repurchase tactic depends on a block of friendly

Under both Delaware and Israeli corporation law, repurchased shares become treasury stock which cannot be voted by the target managers.[232] As a result, defensive stock repurchases automatically increase the percentage of voting stock that is owned by the hostile bidder and may, thus, represent a somewhat risky strategy.[233] However, in light of the Security and Exchange Commission's tender offer rules, which require the bidder to reveal its pre-offer stake in the target,[234] management can avoid particularly risky stock repurchases.

On the other hand, because a repurchase program creates price pressure,[235] it can still be used to defend against a hostile takeover threat. A repurchase program may thwart a pending bid by raising the bidding price beyond what the bidder is willing to pay, or if nothing else, causing the bidder to raise the price.[236] The repurchase program has the effect of increasing the cost to the bidder who is seeking to acquire a controlling interest, without increasing the value of the target. The larger the price pressure effect is, the less attractive the target becomes, and the more likely it is that the bidder, or potential acquirer, will abandon the hostile bid.

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> shareholders whose percentage ownership would increase as a result of the smaller number of shares outstanding . . . .

[232] DEL. CODE ANN. tit. 8 § 160(c) (2001). The Companies Law, 1999, 308 S.H. 189.

[233] *See* Michael Bradley & Michael Rosenzweig, *Defensive Stock Repurchases,* 99 HARV. L. REV. 1378, 1379 n.2 (1986) ("The riskiness of the repurchase strategy will in fact turn on the relative holdings of the outside bidder and target managers and loyalists.").

[234] 17 C.F.R. § 240.14d-100 (2001).

[235] *See infra* pp. 60-61.

[236] "For example, an issuer self-tender at a substantial premium over market may well confuse the bidder, disrupt its planning and timing and cause it to reassess the desirability of the acquisition". GILSON & BLACK, *supra* note 24, at 763, *citing* Nathan & Sobel, *supra* note 229. However, Nathan and Sobel question whether in the absence of an inside non-selling control group (whose position will be enhanced by the self tender), the issuer's self tender, standing alone, will be able to achieve even the goal of causing the bidder to raise his original price. *See id*. at 762.

However, as Gilson and Black point out, [237]

> [M]ore often than not the bidder will have more pricing flexibility and frequently more pricing capability than the issuer. Many issuers are subject to financial covenants that depend upon maintaining certain debt/equity ratios, and more fundamentally, even the most strongly capitalized issuer can only buy back so much of its stock within the limits of sound financial planning.

## VII. Greenmail[238]

The corporation might resort to repurchasing the stock from the hostile bidder for a premium (greenmail), in settlement for having the bidder terminate its efforts take over the company. The economic effect on the corporation would be a reduction in firm value to the extent of the premium paid out to the bidder (or other hostile shareholders). The non-selling shareholders (all shareholders but for the bidder)[239] will effectively pay for the premium through a decrease in the value of their equity.[240]

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[237] *See id*. at 763.

[238] The term "greenmail" describes the practice of accumulating a large percentage of a company's shares (enough to present a threat of control), in order to sell them back to the company at an inflated price.

[239] Since a selective stock repurchase is principally designed to remove a threat to the corporation, other shareholders do not have an opportunity to participate in it. Naturally, a pro rata repurchase offered to all shareholders will not accomplish the goal of eradicating an unfriendly shareholder. *See* Nathan & Sobel, *supra* note 229, at 1554.

[240] Bradley & Rosenzweig, *supra* note 233, at 1395. *See also* Friedman, *supra* note 230, at 560 n.86 (reviewing finance theories that use cumulative abnormal returns (abnormal returns measure the change in a stock's price relative to price changes in an assorted market portfolio) to empirically test the effects of greenmail on shareholders' wealth:

> [R]ecent studies have found that nonparticipating shareholders suffer negative abnormal returns when targeted repurchases effectively kill an offer. *See* The Office of the Chief Economist of the SEC, *The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices* (Sept. 11, 1984), *reprinted in* [1984-1985 Transfer Binder] FED. SEC. L. REP. (CCH) P83, 713 (overall net-of-market abnormal return of negative 3.7% represents direct cost of greenmail payment and indirect cost of lost putative gains from change in control) . . . Dann & DeAngelo, *Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control,* 11 J. FIN. ECON. 275 (1983) (block repurchases at a premium produce negative abnormal returns . . . ).

However, Andrei Shleifer and Robert Vishny argue that greenmail has a positive effect on the wealth of shareholders in that it can be an effective form of signal concerning target management's

However, while both greenmail and dividend distributions cause a reduction in the firm value to the extent of the premium that is paid out, dividends are paid to all shareholders in proportion to their holdings so that all shareholders bear a proportionate share of the capital loss that finances the dividend.[241]

### i. Greenmail As An Archetypical Management Entrenching Defensive Tactic: The Agency Conflict

The use of greenmail to defeat unwanted tender offers has come under attack, among other things, for being used by target management to entrench themselves and retain control, regardless of the corporate welfare and that of its shareholders. This is viewed as another agency cost of the conflict of interest between management and other corporate players.[242]

Several greenmail studies that examined the effect of greenmail on returns, suggest that greenmail is a predominantly entrenching device.[243] By using greenmail,

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information. They defend greenmail as a potential source for gains to target shareholders by drawing additional bidders into the bidding contest, thereby causing price pressure. Andrei Shleifer & Robert Vishny, *Greenmail, White Knights And Shareholder Interest*, 17 RAND J. ECON. 293 (1986).

[241] Larry Dann & Harry DeAngelo, *Standstill Agreements, Privately Negotiated Stock Purchases, and the Market for Corporate control*, 11 FIN. ECON. 275, 294 (1983). *And see* Bradley & Rosenzweig, *supra* note 233, at 1396. These studies reported statistically significant negative abnormal returns over the several days surrounding the announcement of the repurchase. In contrast, studies on the impact of general stock repurchase programs on the target's stock show substantial positive abnormal returns. *See* Theo Vermaelen, *Common Stock Repurchases and Market Signaling: An Empirical Study*, 9 J. FIN. ECON. 139 (1981), *and see* Ronald Masulis, *Stock Repurchases By Tender Offer: An Analysis of the Causes of Common Stock Price Changes*, 35 J. FIN. 305 (1981).

[242] *See* GILSON & BLACK, *supra* note 24, at 787 ("That the control issues puts target management in a position where its interests and those of the shareholders conflict is apparent; that management succumbs to the conflict when it engages in greenmail seemed supported by the empirical data.").

[243] Michael Bradley & Larry Wakefield, *The Wealth Effect Of Target Share Repurchases*, 11 J. FIN. ECON. 301, 308 (1983). *But see* James Ang & Alan Tucker, *The Shareholders Wealth Effects of Corporate Greenmail*, 11 J. FIN. RES. 265 (1988) and other studies cited in GILSON & BLACK, *supra* note 24, at 788 for the proposition that greenmail has the same effect as other successful defensive tactics: "if the defeated bid is not followed by a successful acquisition, the gain that remains after the greenmail payment disappears. Thus some greenmail payments benefit shareholders (if they lead to a subsequent offer) and some greenmail payments entrench management (if they do not)."); on greenmail and the management entrenchment hypothesis see Jonathan R. Macey & Fred S. McChesney, *A Theoretical*

management effectively spends corporate funds to deprive the shareholders the opportunity to receive a premium offer that would otherwise be available to them by selling their shares into a takeover bid at a high price.[244] At the same time, management arguably spends more corporate assets (for the share buyback) than the market presently believes the shares are worth.[245]

## VIII. Stock Manipulations And The Creditor Expropriation Theory

### i. Stock Manipulations

Critics often attack repurchase plans and dividend distributions as manipulative tools applied with the intention of adjusting stock prices. This was one of the main concerns the Israeli draftsman expressed with regard to lifting the limitations on share repurchasing.

In October 1983, Israel's economy underwent a stock market crisis as a direct result of stock manipulations practiced by a cluster of local banks. The banks continuously acquired bank-stocks,[246] contrary to market inclinations, driving stock prices to unreal values. In this process, the banks exhausted a dangerous portion of their resources, bringing the whole banking system and the stock markets to the verge of collapse. As a result, the Israeli government shut down all stock market activity for a period of three weeks to formulate a comprehensive plan to prevent mass cash

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*Analysis of Corporate Greenmail*, 95 YALE L.J. 13 (1985), and Note, *Greenmail: Targeted Stock Repurchases and the Management-Entrenchment Hypothesis*, 98 HARV. L. REV. 1045 (1985).

[244] GILSON & BLACK, *supra* note 24, at 786.

[245] Studies confirm that target companies earn negative abnormal returns when they announce the payment of greenmail. *Id*. at 787.

[246] Though the corporation law at that time generally contained a prohibition on buybacks, the banks took advantage of a loophole in the Companies Ordinance, 1983, which did not clearly prohibit share repurchases by subsidiary corporations.

withdrawal by the public, whose stocks value plunged dramatically, and which provided the main security for the credits which were advanced to repurchase these stocks.[247]

Unsurprisingly, during the 1990s, when Israeli draftsmen sought to do away with the general prohibition on stock repurchasing, their proposals met a loud dissent from the financial community. Nonetheless, in the 1999 version of the Companies Law, these general limitations were deleted and in their place a cautious formula for distribution was approved.

### ii. Creditor Expropriation Theory

Another opposition is directed, in a more general fashion, towards liberal distribution statutes because they under-protect creditors. The creditor expropriation theory posits that new debt issuance causes wealth transfers from the creditors to the shareholders.

Lily Kahng, for example, rationalizes the correlation observed between new debt issuances and share value increases as a wealth transfer from bondholders to shareholders.[248] The wealth transfer hypothesis submits that increasing the risk of the outstanding debt by issuing large amounts of new debt, decreases the value of the outstanding debt, and increases the value of the outstanding stock.[249]

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[247] *See* THE BEYSKI COMM. REPORT ON THE BANKS STOCK MANIPULATION AFFAIR, April 1986, 335 (Isr.); BAHAT, *supra* note 47, at 452; Shmidler & Sheinfeld, *supra* note 157, at 327.

[248] Lily Kahng, *Resurrecting the General Utilities Doctrine*, 39 B.C. L. REV. 1087, 1104 n.68 (1998), *citing* RONALD W. MASULIS, THE DEBT/EQUITY CHOICE, 35-46 (1988). *See also*, GILSON & BLACK, *supra* note 24, at 626.

[249] GILSON & BLACK, *supra* note 24, at 626.

## IX. Stock Redemptions

### i. Redemptions Occurring Pursuant To Previously Negotiated Arrangements

A corporation which redeems its own shares pursuant to a previously negotiated arrangement, is not purchasing its shares in the usual sense of the word. That is, the term "repurchase" suggests that the corporation is reacquiring stock, which was not designated as redeemable from the onset, through a self-tender, an open-market repurchase, or a private repurchase.

#### a. Redeemable Stocks And Preferred Stock

A corporation may choose to include in its charter a provision that its common stock be redeemable at the option of the corporation.

Delaware's G.C.L., section 151(b), expressly provides that, "[a]ny stock of any class or series may be made subject to redemption by the corporation at its option or at the option of the holders of such stock or upon the happening of a specified event."[250]

Similarly, the Companies Law, section 312(a), provides for the issuance of redeemable common stock[251] and their redemption.[252]

In many respects, preferred stockholders resemble bondholders rather than common stockholders. They have lent the business money in return for a flat mandatory dividend. The dividend is paid to the preferred stockholder every set term, regardless of whether it pays a dividend to its common stockholders. By redeeming the preferred

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[250] DEL. CODE ANN. tit. 8 § 151(b) (2001). *See also* John C. Coates IV, "Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions, 147 U. PA. L. REV. 1251, 1290 (1999).

[251] The Companies Law, 1999, 312 (b), (d) S.H. 189.

[252] *See also* BAHAT, supra note 47, at 422 (redeemable stocks are not subject to general distribution limitations because the creditors do not rely on them as part of the equity cushion).

stockholders, the corporation can terminate its obligation to make such compulsory dividend payments.

Thus, management might find it worthwhile redeeming the bondholders when the corporation no longer needs the capital that is represented by their contributions.

**b. Redemptions For The Purpose Of Preserving Ownership Proportions**

Repurchasing stock from the shareholders may also be exercised for the purpose of preserving the proportionate holdings of the remaining shareholders when one of the managers or shareholders leaves the business, dies, or retires, particularly in close corporations. By repurchasing his or her shares, the corporation avoids the kind of control struggle that might be triggered if the residual shareholders competed with each other for the shares. For this reason, shareholders in closely held corporations often sign a redemption agreement in advance.

**ii. Redemption Clauses As Poison Pills**

Poison pill provisions[253] have become a popular method to deter hostile bidders from trying to obtain control over a corporation. A poison pill will effectively dilute any common stock position that the hostile acquirer might establish, thereby, making the target less attractive.

A redemption plan can be installed as a poison pill to deter a takeover attempt.[254] Poison pill redemption plans are sometime referred to as "put" plans. They come into

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[253] Poison pill plans are a type of shark repellent provisions designed to deter or defeat a hostile takeover. The Dictionary of Financial Risk Management, *available at* http://riskinstitute.ch/.

[254] *See* GILSON & BLACK, *supra* note 24, at 738-39; O'KELLEY & THOMPSON, *supra* note 7, at 818:

> [Poison pill] rights lie unused and almost worthless until triggered by a hostile acquisition. At that point the rights explode in a way that makes the

play if a bidder buys some, but not all, of the target's shares. Redemption plans focus on the position of the minority non-tendering shareholders[255] in providing the target shareholders the right to sell back to the corporation their remaining shares in the target, at a "fair price".[256]

Stock redemption plans are reportedly some of the most effective defenses a corporation can adopt. Gilson and Black describe redemption rights as more effective deterrents than others because they have the potential for placing an enormous added financial cost on a hostile bidder,[257]

> If a potential offeror contemplates an offer for less than 100% of the target's stock, a right of redemption provision may remove control over the size of an offeror's total investment from his hands. Because the shareholders may in effect force a second-step transaction by exercising their right to require redemption, they, and not the offeror, have the last word on the number of shares ultimately acquired and, if the provision's pricing formula could yield a price higher than the offeror, on the price that is paid . . . . If the pricing formula assures holdouts a price no lower than the tender offer and provides the potential of a higher price, target shareholders will be given an incentive not to tender in the original offer.

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> acquisition particularly painful for the bidder to digest. In the more popular versions of the pill, the target shareholders get the right to redeem their shares in the target company for a price well above market price . . . . The acquiring company finds itself with a target corporation depleted of assets or fills with new obligations.

[255] The concept of redemption provisions as a put plan originated from the English Companies Act to allow minority shareholders to require the target company to acquire their shares at a formula price that equals or exceeds the price paid by the bidder. It is effective against two-tier front-loaded tender offers where shareholders normally fear that if they do not tender they will be later cashed out in a back-end merger for less than initially offered. Weiss, Elliott J., *Balancing Interests in Cash-Out Mergers: The Promise of Weinberger v. UOP, Inc.*, 8 DEL. J. CORP. L. 1, 58 n.357 (1983).

[256] A "fair price" is essentially the price that the corporation's directors believe is fair. Typically will be equal or greater than the highest price paid by the bidder for any shares acquired during the offer. Note, this type of redemption is distinguishable from redemption of redeemable stocks discussed above.

[257] GILSON & BLACK, *supra* note 24, at 738-39.

Gilson and Black emphasize that the effectiveness of redemption plans as deterrence mechanisms lies not only in their ability to increase the price of the entire acquisition for the offeror, but also remove the offeror's alternative not to proceed with a second-step transaction if the cost appears too great, or its benefits too small.[258] Critics consider the benefits of redemption plans as a defensive tactic alongside with their perils. As with other defensive tactics, redemption plans pose the danger that management will use them to secure their own positions by reducing the likelihood of future tender offers at a premium to the shareholders. Management's increased security has been thought to come at the expense of the shareholders.[259]

The legitimacy of poison pill redemption plans in Israel is doubtful. Though the Companies Law allows the reacquisition of stock[260] (subject to limitations), management's power to thwart bids is generally carefully scrutinized.[261] In addition, the language in section 312 of the Companies Law,[262] seems to suggest that rights of redemption are available solely to redeemable shares.[263]

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[258] *Id*. at 778.

[259] *Id*. at 778.

[260] A corporation may launch a repurchase plan as a defensive response to a hostile bid, however, such plan will have to comply with general distributions principles.

[261] *See* GROSS, *supra* note 40, at p.375. Though the new Companies Law represents a shift from the conservative British version of the Companies Ordinance, it fails to draw a clear picture with respect to the continuation of some of its predecessors' restrictive approaches to takeovers. For instance in the U.K. "the target company cannot take any action that would "frustrate a bid", i.e., no poison pills, no ESOPs, no stock repurchase programs, no sale of assets, no leveraged special dividends unless approved by stockholders." Colloquium, *What Business Will Look For In Corporate Law In The Twenty-First Century*, 25 DEL. J. CORP. L. 6, 10-11 (2000). *And see* Bernard S. Black & John C. Coffee, *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2026 (1994) ("In Britain, defensive powers were limited to begin with and changed little over the decade. There simply are no poison pills, targeted share placements, or lock-up options by which target managers can block a tender offer. The restrictive British approach to takeover defenses may reflect, in part, the political power of British institutions.").

[262] The Companies Law, 1999, 312 S.H. 189.

[263] The shares must have been issued as redeemable shares from the onset. The Companies Law, 1999, 312(d) S.H. 189. *See also* BAHAT, *supra* note 47, at 449 (redeemable shares do not appear in the capital account where the corporation's stock capital appears, unless redemption rights have been limited to the time of dissolution, after all outstanding debt have been paid).

In the absence of more clarifying notes, redemption of common stocks as a takeover defense method must be seen as events subsisting outside the scope of section 312. Until the court sheds some light on the subject, it may be that common stock redemptions will be examined under the general requirements for distributions.

# CHAPTER 6

## RESTRICTIONS ON DIVIDEND DISTRIBUTIONS AND SHARE REPURCHASES

If those with no personal liability could legally withdraw their original investment at any time, they could deprive creditors of the protective cushion that the invested capital arguably provides, that on which they may have relied when advancing money to the corporation. The creditors would further be injures if circumstances permitted unscrupulous equity holders to withdraw, without restrictions, money representing not only their investment, but also that obtained through borrowings. For this reason, corporate law has long restricted the right of corporations to pay dividends and buy back equity.

As previously discussed, share repurchase and dividends have similar effects on the corporation's capital. The corporation pays for the shares with corporate asset, leaving fewer assets in the corporation to guarantee the payment of its debts. Thus far, it is understandable why creditors ideally want to require the corporation to maintain substantial assets throughout the life of the debt, prevent the corporation from placing encumbrances on these assets, and limit payouts to shareholders. These objectives are sustained, to some extent, by limitations posed through the corporate law system.

### I. Restrictive Covenants

Smith and Warner addressed the role of restrictive covenants in the conflict of interest between shareholders, management, and the firm's creditors in 1979. They wrote that "[w]ith risky debt outstanding, stockholders actions aimed at maximizing the value of their equity claim can result in a reduction in the value of both the firm and its outstanding bonds."[264]

As previously discussed, legal capital theories suggest that once the debt has been issued to the corporation the return to shareholders from pursuing risky strategies increases by virtue of the disproportionate allocation of risk between the shareholders and the debtholders.[265] It is generally thought, though, that debtholders anticipate risk-increasing behavior when negotiating the terms of the debt.[266] Debtholders may demand an interest rate that reflects the anticipated increase in risk, and/or put restrictive covenants into place that limit the corporation's ability to make decisions that are risky in fashion.[267]

Both parties, investors and managers, have incentives to make arrangements that reduce risk and thus reduce the premium they must pay to debt claimants.[268] Bond covenants are considered to be in most instances the most suitable fashion to reduce monitoring costs over the corporation.[269]

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[264] Clifford W. Smith, Jr., & Jerold B. Warner, *On Financial Contracting: an Analysis of Bond Covenants*, 7. J. FIN. ECON. 117 (1979).

[265] Fischel, *Lender Liability*, *supra* note 31, at 131.

[266] GILSON & BLACK, *supra* note 24, at 245.

[267] *Id*. at 245-46; George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1093 ("Current corporate scholarship explains covenants as a means of bonding the commitment of the firm to refrain from behavior that redistributes wealth from debtholders to shareholders or from investors as a group to managers.").

[268] Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 105 (1985). S*ee also id.* ("Managers will take steps to reduce risk only so long as the gains from risk reduction exceed the costs.").

[269] Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 15-16 (1991):

> Where monitoring costs are high, the optimal strategy may be for the agent to engage in some form of bonding to assure the principal that the agent will carry out her duty to the principal faithfully even in the absence of effective monitoring. Such bonding can be by means of explicit contracts, as in the

### II. Statutory Limitations

Both Delaware's G.C.L. and Israel's Companies Law, place restrictions on the ability of corporations to deplete their assets through wealth distributions to shareholders.[270]

#### i. Statutory Limitations On Dividends

As discussed above, a Delaware corporation may pay dividends either out of the earned surplus account[271] or the unearned surplus,[272] as long as the capital of the corporation remains intact. In addition, Delaware subscribes the payment of nimble dividends.[273]

Israel provides for payment of dividends out of the earned surplus account,[274] provided that the distribution does not render the corporation unable to pay its debts.[275] In addition, the Companies Law also allows nimble dividends.[276] However, in distinct difference to Delaware, Israel prohibits distributions out of any and all of the stock capital.[277]

#### ii. Statutory Limitations On Repurchases

With respect to share repurchase, an improper repurchase is one that inevitably impairs the corporation's capital.

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case of bond covenants, or by implicit structural features of the principal-agent relationship.

[270] DEL. CODE ANN. tit. 8 § 170(a) (2001); Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27, 50 (1996).
[271] DEL. CODE ANN. tit. 8 § 170(1) (2001).
[272] *Id*. § 170(2).
[273] *See* discussion *infra* p. 40.
[274] The Companies Law, 1999, 302 S.H. 189.
[275] *Id*.
[276] *Id*. § 302(b).
[277] The consideration received for shares and any premiums thereof.

Section 160(a) of Delaware's G.C.L.[278] provides that

> Every corporation may purchase, redeem . . . acquire . . . its own shares; provided, however, that no corporation shall:
> (1) Purchase or redeem its own shares of capital stock . . . when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation . . . .

The Delaware code furnishes the board of directors with broad discretion in dealing with the corporation's own stock. At the same time, the code outlines the marginal limitations of the board's authority. A repurchase is deemed unlawful when it instigates the impairment of capital. The corporation's capital would be impaired when the repurchase price surpasses the amount of the corporation's surplus.[279] Generally, a share repurchase will most likely be forbidden if a dividend of the same amount would be forbidden.

Israel has only recently removed the general prohibition on stock buybacks. The 1999 version of the Companies Law includes the practice of repurchasing stock in the definition for "distribution".[280] As for statutory treatment, the explanatory notes make it

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[278] DEL. CODE ANN. tit. 8 § 160 (2001).

[279] "Surplus" being, the excess of net assets over the par value of the corporation's issued stock. *See also id*. § 160 statutory notes:

> This section is an authorization for a corporation to use its property for the purchase of its own capital stock if such use will not impair its capital. Alcott v. Hyman (citation omitted).
>
> Impairment of capital means its reduction below amount represented by outstanding stock --The impairment of the capital of a company, as used in this section, means the reduction of the amount of the assets of the company below the amount represented by the aggregate outstanding shares of the capital stock of the company In re International Radiator Co. (citation omitted).

*See further* relevant citations *Id*. (DEL. CODE ANN. tit. 8 § 160 statutory notes (2001), *In re Motels of Am., Inc*., 146 Bankr. 542 (Bankr. D. Del. 1992), *and Klang*, 702 A.2d at 150.

[280] The Companies Law, 1999, 301 S.H. 189.

abundantly clear that share repurchases and dividend distributions will be treated in the same way subject to the general requirements for making distributions.[281]

### iii. Insolvency Test

Entirely apart from the surplus or impairment of capital standards, both Delaware and Israel generally prohibit the distribution of dividends that would consequently leave the corporation insolvent.[282] A share repurchase or a dividend distribution made at a point where the corporation was insolvent or that caused the corporation to enter insolvency will be deemed illegal.

In Delaware, the prohibition on dividends or repurchases that would lead to insolvency is not contained in the corporation's statutes themselves.[283] There is some uncertainty as to what mechanism Delaware courts will apply in evaluating whether a corporation has become insolvent.[284] Mechanisms for determining insolvency may include equitable insolvency (the inability to pay debts as they become due),[285] balance sheet insolvency, or bankruptcy insolvency (balance sheet negative net worth; where reported liabilities exceed the book value of assets),[286] or other statutory definitions.[287]

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[281] The Companies Bill, explanatory notes § 345; GROSS, *supra* note 40, at 335.

[282] The courts will intervene in circumstances where dissemination of assets substantially diminishes creditors' security. *See* DEL. CODE ANN. tit. 8 § 160 statutory notes (2001) *citing* Pasotti v. United States Guardian Corp. 18 Del. Ch. 1, 156 A. 255 (1931), *and In re* International Radiator Co., 10 Del. Ch. 358, 92 A. 255 (1914). *See also* The Companies Law, 1999, 302 S.H. 189.

[283] The prohibition appears in non-corporation statues, which protect creditors. *See* Roberts & Pivnick, *supra* note 147, at 67-68 ("Delaware laws provide that no dividend shall be paid if the dividend exceeds the surplus -- the DGCL, contains no insolvency language. . . . And while no solvency test exists for Delaware distributions, a distribution may be set aside as fraudulent."). *See also* DEL. CODE ANN. tit. 8 § 170(a) (2001).

[284] *See* Barondes, *supra* note 9, at 49 n.10.

[285] Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1480 n.57 (1993).

[286] *Id*. at 1480 n.58.

[287] *E.g.*, the Bankruptcy Code's definition [11 U.S.C. § 101(32)(2001)], the Uniform Fraudulent Conveyance Act's definition [UNIF. FRAUDULENT CONVEYANCE ACT § 2(1), 7A U.L.A. 442(2001)], the Uniform Fraudulent Transfer Act's definition [UNIF. FRAUDULENT TRANSFER ACT § 2(a), (b), 7A U.L.A. 648 (2001)].

Some writers support the proposition that a Delaware corporation may be considered insolvent either when its liabilities exceed its assets, or when the corporation is unable to meet its current obligations arising in the ordinary course of business**.**[288] In *Geyer v. Ingersoll Publications Co.*,[289] the Chancery Court of Delaware declared that in the context of examining directors' liability for unlawful distributions insolvency could occur under either a negative net assets test or a cash flow test.[290]

Other writers suggest that there is some evidence that Delaware courts are likely to favor equitable insolvency, which like the Israeli formula, focuses on the corporation's inability to pay its debts as they become due.[291]

The Companies Law expressly integrates an equitable insolvency test in the general test for distribution. Section 302(a) of the Companies Law provides that a distribution could be deemed unlawful where it raises "reasonable concern"[292] that it could ultimately lead the corporation into a position where it is unable to pay its debts (outstanding and foreseeable) as they become due.[293]

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[288] FOLK ON THE DELAWARE GENERAL CORPORATION LAW: FUNDAMENTALS § 291.2 at 749 (Edward P. Welch & Andrew J. Turezyn eds., 1997) *cited in* Barondes, *supra* note 9, at 49 n.10.

[289] 621 A.2d 784 (Del. Ch. 1992).

[290] *See* i*d*. (referencing Webster's definition of insolvency. Webster's Ninth New Collegiate Dictionary 626 (1988), citing the 1899 case of *McDonald v. Williams* for the proposition that that a corporation is as a matter of fact insolvent once "the value of its assets has sunk below the amount of its debts". McDonald v. Williams, 174 U.S. 403, 43 L. Ed. 1022, 19 S. Ct. 743 (1899)).

[291] *See* Andrew D. Shaffer, *Corporate Fiduciary - Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About*, 8 AM. BANKR. INST. L. REV. 479, 515 (2000).

[292] The "reasonable concern" element does not require a showing of certainty, or even near certainty, that the distribution will hinder the corporation's ability to meet its obligations. What is required is a showing that there is a real possibility that the distribution will generate genuine difficulties in doing so. *See* GROSS, *supra* note 40, at 345. The reasonable concern test represents a conservative approach because it accepts, as sufficient, evidence that is based on the average probability that the distribution will negatively affect the financial stability of the corporation. *See id*. The reasonable concern test is criticized for placing a heavy burden on management, and for, arguably, providing too wide a protection to the creditors. For one thing, once the corporation reaches financial distress, the court will scrutinize management's behavior, in hindsight. The creditors will typically claim that the distribution was illegal because it resulted in financial distress. Second, the test ultimately requires management to obtain financial forecasts which are indeterminate parameters in nature. *Id*.

[293] The Companies Law, 1999, 302(a) S.H. 189.

## III. Limitations Imposed By Case Law

### i. Imposing Fiduciary Duties On Directors Of Insolvent Or Near Insolvent Corporations

It is generally accepted that under U.S. law, the directors of a *solvent* corporation do not owe the creditors any duty other than duties arising with respect to compliance with the terms of the debt.[294] The rationale is that because the relationship between the bondholders and the corporation is contractual in nature, the bondholders, in theory, have had an opportunity to negotiate the terms of that relationship, and incorporate any necessary or desired protections into the indenture.[295]

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[294] *See* David Thomson, Directors, Creditors and Insolvency: A Fiduciary Duty or a Duty Not to Oppress?, 58 U.T. FAC. L. REV. 31, 44 (2000) citing Webb v. Cash, 35 Wyo. 398 (1926):

> [I]n *Webb* v. *Cash*, the Supreme Court of Wyoming held that it is difficult to perceive upon what principle a director of a corporation can be considered a trustee of its creditors. He is selected by the shareholders, not by creditors; he has no contractual relation with the latter; he represents a distinct entity, the corporation; and his relations to its creditors is exactly the same as the agent of an individual bears to creditors of such individual; and it is not pretended that in the latter case the agent would be the trustee of the creditors of his principal. And we think that by the great weight of authority such trust relation is distinctly repudiated, *when the corporation is a going concern*.

*And see* Nicholson, supra note 31, at 574-76:

> Where a corporation is solvent, Delaware courts have held that the only duty directors owe bondholders is to adhere to the terms of the bond indenture or contractual agreement.
>
> . . .
>
> In the context of the solvent corporation, it is settled Delaware law that directors do not owe bondholders any duty other than compliance with the terms of the bond indenture. . . . That contractual relationship generally recognizes that bondholders have lent money to the corporation and, in return, are entitled to the repayment of their loan plus interest.

*See also* Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (the relationship between the corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature); Harff v. Kerkorian, 324 A.2d 215, 222 (Del. Ch. 1974), rev'd on other grounds, 347 A.2d 133 (Del. 1975) ("It is apparent that unless there are special circumstances which affect the rights of the debenture holders as creditors of the corporation . . . the rights of the debenture holders are confined to the terms of the Indenture Agreement pursuant to which the debentures were issued."); *See generally* BAHAT, supra note 47, at 687-90.

[295] Nicholson, *supra* note 31, at 576; BAHAT, *supra* note 47, at 302.

Delaware's Supreme Court recently articulated this principle in the case of *Simons v. Cogan*,[296] where Judge Walsh J., for the Court, held that a fiduciary duty is not owed to holders of convertible debentures:[297]

> Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist . . . . Until the debenture is converted into stock the convertible debenture holder acquires no equitable interest, and remains a creditor of the corporation whose interests are protected by the contractual terms of the indenture.

In sharp contrast, once a Delaware corporation becomes insolvent or, as recent case law suggests, is on the brink of insolvency, the directors are held accountable to the corporation's creditors as well as to its shareholders.[298]

That directors owe creditors fiduciary duties at the point of insolvency has long been recognized in the U.S. under the trust fund doctrine. The trust fund doctrine was developed in a trilogy of cases, discussing (with varying degrees of acceptance) the doctrine[299] first articulated in the landmark case of *Wood* v. *Dummer*.[300] The court in *Wood v. Dummer* held that the capital stock of a corporation comprises "a trust fund for the payment of all the debts of the corporation." The court went on to say that,

> The bill-holders and other creditors have the first claims upon [the capital stock of the corporation]; and the stockholders have no rights, until all the other creditors are satisfied . . . . On a

[296] 549 A.2d 300 (1988).

[297] *Id*.

[298] Nicholson, *supra* note 31, at 574 ("[W]hen a corporation becomes insolvent, Delaware courts say that directors become de facto trustees of the corporate assets for the benefit of creditors. Thus, a corporation's insolvency shifts the board's obligations from its shareholders to its creditors."). *And see* Credit Lyonnais Bank Netherland, N.V. v. Pathe Communications Corp., 1991 Del. Ch. LEXIS 215 (on directors' duties at the brink of insolvency).

[299] *See* Asmussen v. Quaker City Corp., 156 A. 180 (Del. Ch. 1931), *and* Pennsylvania Co. for Insurances v. South Broad Street Theatre Co., 174 A. 112 (Del. Ch. 1934) (the courts rejected its application to Delaware corporations). *And see Bovay* v. *H.M. Byllesby & Co*., 38 A.2d 808 (Delaware's Supreme Court acknowledged the doctrine, but limited its application to Delaware corporations). *See also generally* Nicholson, *supra* note 31, at 580-81.

[300] 30 F.Cas. 435.

> dissolution of the corporation, the bill-holders and the stockholders have each equitable claims, but those of the bill-holders possess . . . . a prior exclusive equity.[301]

This principle was widely reiterated in cases that followed.[302]

The Supreme Court of Delaware recognized the trust fund doctrine in 1944 in the case of *Bovay* v. *H.M. Byllesby & Co*.,[303] stating that,

> An insolvent corporation is civilly dead in the sense that its property may be administered in equity as a trust fund for the benefit of creditors. The fact which creates the trust is the insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency.

Having made that statement, the court qualified the fiduciary role of directors, holding that, "corporate officers and directors, while not in strictness trustees, will . . . be treated as though they were in fact trustees of an express and subsisting trust . . . especially where insolvency of the corporation is the result of their wrongdoing."[304]

Since *Bovay*, the directors of a Delaware corporation are held to the high standards of conduct that trustees are held to, and owe fiduciary duties to the creditors of

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[301] *See* id. at 436-37.

[302] Davis v. Woolf, 147 F.2d 629, 633 (4th Cir. 1945):

> [W]hen a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but by the fact of insolvency, become trustees for the creditors, and that they then can not by transfer of its property or payment of cash, prefer themselves or other creditors, and that this is so, independently of any of the provisions of the national bankruptcy law.

*See also* Automatic Canteen Co. of America v. Wharton, 358 F.2d 587, 590 (2nd Cir. 1966) ("directors of an insolvent corporation occupy a fiduciary position toward the creditors, just as they do toward the corporation when it is solvent.").

[303] 38 A.2d 808, 813 (Del. 1944) (Layton C.J.) (citing *McDonald v. Williams*, 174 U.S. 397, 19 S. Ct. 743, 43 L. Ed. 1022 (1899)).

[304] *Bovay*, 38 A.2d at 820.

the corporation when a corporation becomes insolvent. But, the directors are not in that sense "trustees" of corporate assets for the creditors.[305]

Recently, Delaware's Court of Chancery revisited the rule that directors owe fiduciary duties upon insolvency. In *Geyer*,[306] the court held that the duty arises once the corporation enters, what the panel termed, "insolvency in fact".[307] The court reiterated the rule that "when the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors."[308]

In *Credit Lyonnais Bank Netherland, N.V.* v. *Pathe Communications Corp.*,[309] The Court of Chancery leaped a step further by imposing fiduciary duties on directors of Delaware corporations, even prior to the point of insolvency.[310] In *Credit Lyonnais*, Chancellor Allen held that when a corporation is in the "vicinity of insolvency",[311] the directors' duty of loyalty is owed to the corporate enterprise as a whole. The court stated that,[312]

> At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.
>
> . . .
>
> [The board has] an obligation to the community of interests that sustained the corporation to exercise judgment in an informed, good faith effort to maximize the corporation' s long-term wealth creating capacity.

[305] Thomson, *supra* note 294, at 45; Nicholson, *supra* note 31, at 582.

[306] *Geyer*, 621 A.2d 784.

[307] The issue in *Geyer* was not whether fiduciary duties existed, but rather, whether the duties were triggered when the corporation became insolvent in fact, or when statutory proceeding (such as bankruptcy) where instigated.

[308] *Geyer*, 621 A.2d at 787.

[309] 1991 Del. Ch. LEXIS 215.

[310] Chancellor Allen relies on the principles of the overinvestment theory to explain why creditors of an insolvent or near insolvent corporation should be burdened with such duties. *See Credit Lyonnais*, 1991 Del. Ch. LEXIS at *108 n.55.

[311] *See* id. *See also id.* at *108-09.

[312] *Id.* at *108-09.

The general rule that appears to have submerged is that the directors of a corporation, which is in the vicinity of insolvency, owe a duty not to any particular group, such as shareholders or creditors, but to the community of interest that impacts a corporation at large. As such, they are to disregard the conflicting incentives of the various claimants and must not attempt to promote the interests of one group at the expense of another.[313]

The duty, as per Chancellor Allen, is to maximize the long-term wealth of the corporation.[314] However, according to earlier holdings, the appropriate time horizon to be considered by the board of directors for the purpose of shaping corporate strategies included long-term values and strategies as well as short-term ones.[315]

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[313] Barondes, *supra* note 9, at 66.

[314] The board has an obligation to "maximize the corporation's long-term wealth creating capacity." *See Credit Lyonnais*, 1991 Del. Ch. LEXIS at *109.

[315] Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1990),

> Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives. 8 *Del. C.* § 141(a). The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. . . . Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.

*And see* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1386 (in the context of determining the reasonableness of a stock repurchase program) ("Distinctions among types of shareholders are neither inappropriate nor irrelevant for a board of directors to make, e.g., distinctions between long-term shareholders and short-term profit-takers, such as arbitrageurs, and their stockholding objectives."). *But see* Barondes, *supra* note 9, at 70-71(*Credit Lyonnais* limits the discretion of the board available under *Paramount*):

> *Paramount* was decided in 1990, before the 1991 decision in *Credit Lyonnais*. Therefore, the discussion of a time horizon in the *Credit Lyonnais* opinion only has meaning if it is intended to exclude a reference to another time horizon, i.e., shorter time horizons. Since *Paramount* generally grants directors the authority to select the relevant time horizon, including shorter time horizons.

Up to *Credit Lyonnais* Delaware case law appeared to have shaped a somewhat simple formula: while the corporation was solvent, *Simons v. Cogan*,[316] released directors of all but their contractual duties to bondholders.[317] Once insolvency in fact occurred, *Geyer*[318] burdened directors with fiduciary duties to the creditors.[319]

*Credit Lyonnais* has been criticized for upsetting the dichotomy of duties between solvency and insolvency, both in terms of the trigger mechanism and the scope of the duty owed. One critic describes Chancellor Allen's statement in that case as,

> [R]egrettably ambiguous in its timing and scope, unrealistic in its expectations, and lacking in a procedural enforcement mechanism. Chancellor Allen' s holding is also unnecessarily narrow by virtue of its limited applicability; that is, it apparently applies only to corporations in the vicinity of insolvency and not to those that are, in fact, insolvent.[320]

However, one element of Chancellor Allen's holding appears clear to most scholars. This versatile fiduciary duty is seemingly short-lived and confined to that period of time when the corporation is in the vicinity of insolvency. Then, reverting to *Geyer*[321] once a corporation is, in fact, insolvent, directors owe a fiduciary duty only to the creditors.[322] Nonetheless, the statement in *Credit Lyonnais*, that the triggering event is when the company is in the vicinity of insolvency,[323] appears inconsistent with the decision in *Simons v. Cogan*[324]and other case law,[325] which pronounce that directors of

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[316] 549 A.2d 300. *Simons* restated and shaped the principles of *Katz v. Oak Indus*., Inc., 508 A.2d 873 (Del. Ch. 1986), and *Harff v. Kerkorian*, 324 A.2d 215 (Del. Ch. 1974).

[317] *See infra* pp. 80-81.

[318] *Geyer*, 621 A.2d 784 reiterated and qualified the principles laid by *Harff*, 324 A.2d 215 and *Bovay*, 38 A.2d 808.

[319] *See supra* note 298 and accompanying text.

[320] Nicholson, *supra* note 31, at 575.

[321] *Geyer*, 621 A.2d 784.

[322] *Id*. at 787.

[323] *See Credit Lyonnais*, 1991 Del. Ch. LEXIS at *108.

[324] *Simons*, 549 A.2d 300.

[325] *E.g*., *Katz*, 508 A.2d 873 *and Harff*, 324 A.2d 215.

solvent corporations owe the creditors no other duties but contractual duties related to the debt. It seems further inconsistent with *Geyer*[326] where Vice Chancellor Chandler announced that it is "insolvency in fact" that triggers the existence of fiduciary duties to creditors, not the threat or possibility of insolvency.

Moreover, "vicinity", being presumably somewhere between solvency and insolvency, creates practical difficulties in that it is not readily identifiable by directors.[327] The difficulty in satisfying the obligation may very-well cause managers to be unaware that the corporation is in the vicinity of insolvency or has crossed the threshold and entered the realm of insolvency.

*Credit Lyonnais* proposes that when in the vicinity of insolvency, directors owe a duty not to a single constituency but to the corporation's community of interests.[328] At the same time the Court fails to instruct us as to the breadth of the "community" that directors need to consider. Commentators propose that while Chancellor Allen may have failed to specify the constituencies that might belong to this community of interests, perhaps what had in mind was the list of stakeholders described in *Unocal Corp.* v. *Mesa Petroleum Co.*[329] whose interests can be considered when a takeover is threatened.[330]

Another amorphous element of the court's decision in *Credit Lyonnais*, is the announcement that the objective of the directors in such instances is to maximize the

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[326] *Geyer*, 621 A.2d 784.

[327] Thomson, *supra* note 294, at 44 ("[I]t will be difficult for them to identify the point at which their duties to creditors switch from contractual to fiduciary in nature.").

[328] *See Credit Lyonnais*, 1991 Del. Ch. LEXIS at *109.

[329] 493 A.2d 946, 955 (1985).

[330] *See* Thomson, *supra* note 294, at 44 (in the context of hostile takeovers. In *Unocal*, 493 A.2d at 955, the court upheld a directorial decision to consider other constituencies when facing a hostile takeover: creditors, customers, employees, and the community. There would be no duty, however, to consider other constituencies when a takeover is inevitable. In such circumstances, the duty can be discharged by

firm's wealth creating capacity.[331] To begin with, the meaning of the word "wealth" is not self-evident[332] and neither is the extent to which the firm's capital structure is to be incorporated in measuring wealth.[333] Other critics point to further uncertainties surrounding the *Credit Lyonnais* decision with respect to the application of the business judgment rule,[334] potential conflicts with previous case law,[335] and procedural difficulties in enforcing the standard.[336]

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obtaining a maximum share price for the tendering shareholders. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (1986).

[331] *See Credit Lyonnais*, 1991 Del. Ch. LEXIS at *109.

[332] Barondes, *supra* note 9, at 72. *See also id.* at 73-74:

> [E]ven if "wealth" references profits determined in accordance with Generally Accepted Accounting Principles ("GAAP"), consistently applied, a court frequently would be unable independently to assess whether a particular decision made by directors maximized "wealth." The ambiguity as to the definition of "wealth" thus creates additional uncertainty.

[333] *See* i*d*. at 74:

> Even more problematic is the test's ambiguity regarding the extent to which the firm's capital structure is incorporated in the wealth assessment. That is, the opinion does not resolve the level of abstraction at which the "wealth creating capacity" is judged. A firm's capital structure may affect its ability to pursue various strategies. Access to capital may require incurring transaction costs that vary depending on the firm's current capital structure.

[334] *See* Nicholson, *supra* note 31, at 589:

> [The business judgment rule] was not an issue [in *Credit Lyonnais*] because Chancellor Allen found the executive committee's actions to be highly prudent and reasonable under the circumstances . . . . . It must be conceded, however, that nothing in the opinion precludes the rule' s use and given its availability in other reviews of director actions it would presumably also be available here.

On the business judgment rule see generally *Revlon*, 506 A.2d at 180 and Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (the business judgment rule is a legal presumption that is afforded to the directors of a corporation that in making a business decision the directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company).

[335] In *Revlon*, the Delaware Supreme Court stated, "[a] board may have regard for various constituencies in discharging its responsibilities, **provided there are rationally related benefits accruing to the stockholders**." [emphasis added]. *Revlon*, 506 A.2d at 182-84. Brent Nicholson proposes that,

> Arguably, in Credit Lyonnais, there are no "rationally related benefits accruing to the stockholders" from the directors' actions. Revlon, on one hand, may be distinguished because it involves a solvent corporation

In Israel, numerous legal scholars considered the issue of directors' duties to creditors.[337] The general accord is that while it remains uncertain whether, and to what extent, directors owe a duty to creditors while the corporation is solvent,[338] it is clear that a special duty exists once the corporation enters insolvency.[339]

The new Companies Law establishes a unique exception to the general rule, which limits the right of creditors to initiate judicial proceedings, to situations of liquidation.[340] The exception under section 204 of the Companies Law affords the

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> undergoing a hostile takeover. On the other hand, the opinion rejects an attempt to protect noteholders at the expense of shareholders.

*See* Nicholson, *supra* note 31, at 590.

[336] Nicholson, *supra* note 31, at 590; Barondes, *supra* note 9, at 66:

> *Credit Lyonnais* did not clearly address whether the duties articulated in the case are affirmatively enforceable by creditors, i.e., whether creditors of a distressed corporation can bring a lawsuit against the directors for pursuing business strategies that do not promote the firm's long-term wealth creating capacity. The case could be read as merely granting directors of distressed corporations an additional basis on which they could defend against lawsuits filed on behalf of disgruntled shareholders.

[337] Yechiel Bahat, *Tachlit Ha'hevra Umatroteya Behatza'at Hok Hahavarot, 1995* [*The Purpose and Objectives of the Company in the Companies Bill, 1995*], A(3) SHA'AREI MISHPAT 277, 299-303 (June 1998) (hereinafter Bahat, *The Purpose and Objectives of the Company*); YECHIEL BAHAT, THE LAW OF CORPORATE CONVALESCENCE 64-65 (2d ed. 1991); Uriel Procaccia, *Haba'alut Al Hafirma Vesyageyah: Noshim, Ovdim, Almanot Veyetomim Bedinei Hahavarot* [*Firm Ownership and Its Margins: Creditors, Employees, Widows and Orphans in Corporate Law*], 22 MISHPATIM, 301, 308-312 (1993); Zipora Cohen, *Hovat Hazehirut Shel Hadirector Bahevra Hareshuma* [*Duty of Care of Directors in Registered Companies*], 1 MEHKAREI MISHPAT, 173 (1980).

[338] *See* Bahat, *The Purpose and Objectives of the Company*, *supra* note 337, at 299 (the rights arising from the contractual relationship between the creditors and the corporation is not enough to give rise to a special duty to consider the creditors' interests in the management of the enterprise).

[339] *Id*. (the duty to consider the creditors' interest is clear, at least with respect to insolvent corporations); Zipora Cohen, *Directors' Negligence Liability to Creditors: A Comparative and Critical View*, 26 IOWA J. CORP. L. 351, 355 (2001) (hereinafter Cohen, *Directors' Negligence Liability to Creditors*):

> A creditor cannot be allowed to intervene in matters connected with the conduct of the corporation's business, so long as the corporation meets its obligations toward him. If the corporation becomes insolvent, there is justification for enabling the creditor to bring an action against the directors in respect to the manner in which they conduct the business of the corporation, which has led to his inability to be repaid by the corporation.

[340] This rule is generally applicable in Delaware.

creditors the right to bring a derivative action against the directors for unlawful distributions.[341] Delaware, in contrast, grants standing only to creditors of corporations that are at the stage of insolvency or dissolution.[342]

However, whether or not this exception, standing alone, confers fiduciary duties on the directors is not self-evident. Bahat identifies a general duty to creditors in sections 274, 308 and 309 of the Companies Ordinance, 1983, vis-à-vis provisions discussing creditors' meetings and the requirement to consider their stand. Gross identifies a general duty by directors to consider the position of *major* creditors, as a prerequisite to the application of the business judgment rule presumptions, when directors consider the ability of the corporation to meet its obligations.[343]

Zipora Cohen concludes that the directors are not liable to creditors "even when the law enables a corporate officer to take into account the benefit to the creditors".[344] Cohen relies on the recently introduced section 11 of the Companies Law[345] to suggest that while the provision does empower the directors to consider the interests of various constituencies, including those of the creditors, shareholders, employees, and, perhaps,

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[341] The Companies Law, 1999, 204, S.H. 189.

[342] DEL. CODE ANN. tit. 8 § 174(a) (2001):

> [T]he directors . . . shall be jointly and severally liable, at any time within 6 years after paying such unlawful dividend or after such unlawful stock purchase or redemption, to the corporation, and to its creditors in the event of its dissolution or insolvency, to the full amount of the dividend unlawfully paid, or to the full amount unlawfully paid for the purchase or redemption of the corporation's stock, with interest from the time such liability accrued.

[343] GROSS, *supra* note 40, at 345 (to enjoy the presumptions of the business judgment rule management will have to show, that in making the decision, they have duly considered the financial disposition of the corporation, the long and short term objectives of the corporation, the advise of financial advisers, and most importantly, the affect it would have on the creditors). *See also* The Companies Law, 1999, 302 S.H. 189.

[344] Cohen, *Directors' Negligence Liability to Creditors*, *supra* note 339, at 355.

[345] The Companies Law, 1999, 11, S.H. 189.

even the public at large, the provision does not entitle them to bring an action on the grounds that their interests were not weighed properly.[346]

Israeli legal scholars further raise the possibility that directors owe creditors fiduciary duties when the corporation is near insolvency.[347] Israeli courts may wish to re-examine Delaware's approach on this issue in the aftermath of *Credit Lyonnais*. Royce Barondes proposes, that in the aftermath of *Credit Lyonnais*, creditors may have the right to bring a cause of action against directors by alleging that the directors failed to promote the creditors' interests when the corporation was nearly insolvent.[348] He writes,

> Credit Lyonnais may be read as creating an obligation to stakeholders who are not shareholders that those stakeholders can enforce. In the alternative, Credit Lyonnais may merely be permissive--it may permit directors of nearly insolvent corporations to consider interests whose consideration otherwise would be improper under otherwise applicable fiduciary duty of loyalty requirements.[349]

Israeli academics further make references to English common law on the subject that, while is not a controlling precedent, is regarded as laying the groundwork for acknowledging such a duty in Israeli law.

Bahat argues, that the body of English case law supports the proposition that a duty to creditors indeed subsists, though its extent is controversial.[350] For instance, in

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[346] Cohen, *Directors' Negligence Liability to Creditors*, *supra* note 339, at 355.

[347] Bahat, *The Purpose and Objectives of the Company*, *supra* note 337, at 299 (at the point of insolvency, and perhaps near insolvency, the corporation has a general duty, intertwined with that owed to the creditors, to maintain profits, diminish losses, and contemplate risks as central objectives in the survival of the corporation).

[348] Barondes, *supra* note 9, at 71. *See also* id. at 69-70 (Delaware case law subsequent *Credit Lyonnais*).

[349] *Id*. at 69.

[350] *See* Lornho Ltd. v. Shell Petroleum Co. Ltd. [1980] 1 W.L.R. 627, 634; Rolled Steel Products (Holding) Ltd. v. British Steel Corp [1985]; Re Horsley & Weight Ltd. [1982] 3 All E.R. 1045; Multinational Gas & Petrochemical Co. Ltd. v. Multinational Gas & Petrochemical Co. Services Ltd. [1983] Ch. 258, 288; [1983] 3 W.L.R. 492, 519 (C.A.).

*Kinsella* v. *Russell Kinsella Pty. Ltd. (In Liq)* (1986),[351] Street C.J. held that though shareholder interests hold primacy in the context of a solvent corporation, once the corporation is insolvent then the interests of the creditors intrude,

> They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, though the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.[352]

This holding appears to suggest that insolvency triggers the onus of fiduciary duties to creditors, in substitution of the shareholders that were previously the corporation's *qua* beneficiaries.[353] However, further in his opinion Street C.J. clarifies that, "the directors' duty to a company as a whole [merely] extends in an insolvency context to not prejudicing the interests of creditors", as opposed to substituting the beneficiaries.[354]

Davis Thomson, an English scholar, asserts that these remarks indicate that, "rather than triggering the wholesale substitution of the body of creditors for the body of shareholders, insolvency alters the relative weight that directors should give to shareholder interests as opposed to creditor interests."[355] Thomson argues that, at all times, the directors' fiduciary duty is owed to the company and no separate duty to creditors exists.

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[351] 4 N.S. W.L.R. 722.
[352] *Kinsella*, 4 N.S. W.L.R. 722, 730.
[353] Thomson, *supra* note 294, at 39.
[354] *Kinsella*, 4 N.S.W.L.R. 722, 732.
[355] Thomson, *supra* note 294, at 40.

In another British case, *In Re Horsley & Weight Ltd.*,[356] Buckley L.J. for the court stated,

> [I]t is a misapprehension to suppose that the directors of a company owe a duty to the company's creditors to keep the contributed capital of the company intact . . . . It may be somewhat loosely said that the directors owe an indirect duty to the creditors not to permit any unlawful reduction of capital to occur, but I would regard it as more accurate to say that the directors owe a duty to the company in this respect.[357]

Templeman L.J. (concurring) further stated, "if the company had been doubtfully solvent at the date of the grant to the knowledge of the directors, the grant would have been both a misfeasance and a fraud on the creditors for which the directors would remain liable."[358]

Thomson[359] and Bahat[360] read these statements as suggesting that when the corporation enters insolvency or is at the verge of insolvency, directors could owe a duty directly to creditors.

Lord Templeman, however, had the opportunity to later clarify his position in *Winkworth* v. *Edward Baron Development Co. Ltd*, (1987)[361] (a unanimous decision of the House of Lords) stating,[362]

> [A] company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obligated to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. The conscience of the company, as well as its management, is confided to its directors. A duty is owed

[356] [1982] 3 W.L.R. 431.
[357] *Horsley*, 3 W.L.R. 431 at 442.
[358] *Id.* at 443.
[359] Thomson, *supra* note 294, at 42.
[360] Bahat, *The Purpose and Objectives of the Company, supra* note 337, at 301 n.99.
[361] 1 All E.R. 114.
[362] *Id*. at 118.

> by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.

Thomson interprets Lord Templeman's statement to mean that directors owe some form of duty to creditors that parallels the duty owed to the company. This duty arises, per Thomson, regardless of whether the company is solvent or insolvent.[363] However, Thomson emphasizes that nowhere in Lord Templeman's statement does he explicitly state that the duty is fiduciary in nature.[364] Thomson interprets Lord Templeman's decision to say that the duty owed by directors to creditors is, merely, "an extension of the contractual duty owed by the company to creditors, not an extension of the fiduciary duty owed by directors to the company" and as such, would arise apart from insolvency.[365]

Hence far, Thomson concludes that the general position under U.K. law is that, "directors do not owe a fiduciary duty directly to creditors." The directors owe a fiduciary duty only to the corporation. However, the company enters into a state of insolvency, "the duty to the corporation must be exercised in a manner that does not disregard or prejudice the interests of creditors."

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[363] Thomson, *supra* note 294, at 42.

[364] *See* id.

[365] *See* id.; Kuwait Asia Bank EC v. National Mutual Life Nominees Ltd. [1990] 3 All E.R. 404 (Lord Templeman concurring) (clarifying that a fiduciary relationship does not normally exist between directors and creditors. Directors may owe a duty to creditors that is contractual in nature or a duty will be implied where the creditor relies upon a certain representation. However, such duties are independent and different from the fiduciary duty that the directors owe the corporation, and would arise regardless of whether or not the company became insolvent); West Mercia Safetywear Ltd. (Liq.) v. Dodd [1988] P.C.C. 212, 215 (the Court of Appeal held that a director "was guilty of a breach of duty when, for his own purposes, he caused £ 4,000 to be transferred in disregard for the interests of the general creditors of [an] insolvent corporation." The Court distinguished its decision from an earlier ruling (Multinational Gas v. Multinational Services [1983] Ch. 258 at 288 (C.A.)), where it held, that directors do not owe fiduciary duties to the creditors of a solvent corporation).

Though English common law may have historically been the predominant thrust in the development of Israeli jurisprudence, it has since taken on a personality of its own. With respect to fiduciary duties, for one, the Supreme Court of Israel and legal writers repeatedly demonstrate an open-minded approach to views expressed by American courts.

Bahat interprets the aforementioned English precedents, as leaving an open door on the scope of the duties owed by directors to corporate creditors.[366] Furthermore, the Supreme Court has recently stated, obiter dicta though, that the shareholders of an Israeli corporation may handle corporate assets as they see fit, provided that third party interests, such as creditors' interest, are not implicated.[367]

Therefore, with English precedent on its heels and, perhaps, American law in the horizon the future of directors' liability to creditors remains open.

**ii. Improprieties Of Share Repurchase**

Delaware law recognizes that the position of creditors (and shareholders) might be prejudiced in the event of a repurchase.[368] Therefore, Delaware courts require directors to employ utmost good faith and good judgment before carrying out repurchase plans[369] and does not afford them the automatic presumption of the business judgment rule.[370]

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[366] Bahat, *The Purpose and Objectives of the Company*, *supra* note 337, at 301.

[367] C.A. 995/90 Adoram Engineers Ltd. v. Hanna Gat & Others, TAKDIN ELYON 92(2), 2378 (S. Ct. Isr.).

[368] *See* DEL. CODE ANN. tit. 8 § 160 statutory notes (2001), Propp v. Sadacca, 40 Del. Ch. 113, 175 A.2d 33 (1961) *modified* 41 Del. Ch. 14, 187 A.2d 405 (1962). *See also* City Capital Assocs. v. Interco, Inc., 551 A.2d 787, 796 (Del. Ch. 1988) ("*Unocal* recognizes that human nature may incline even when acting in subjective good faith to rationalize as right that which is merely personally beneficial.").

[369] *Id*.

[370] DEL. CODE ANN. tit. 8 § 160 statutory notes (2001).

Directors of a Delaware corporation owe fiduciary duties of loyalty[371] and of care[372] to both the corporation and its stockholders.[373] Traditionally, the business judgment rule affords the directors with a legal presumption that in making a business decision, the directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.[374] Looking at both the procedural propriety of the decision[375] and the decision itself, the court will not substitute their business judgment for that of the board if the board's decision, "can be attributed to any rational business purpose."[376]

Israeli draftsmen acknowledge too, that in certain circumstances, particularly where the corporation is not lucrative, the shareholders and/or the directors may attempt to export the remaining assets for their benefit, to avoid having to pay them to the

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[371] "[The duty of loyalty] instructs directors to be absolutely fair and candid in pursuing personal interests. Thus, it makes it wrongful for a director unfairly to compete with her corporation or unfairly to divert corporate resources or opportunities to her personal use." O'KELLEY & THOMPSON, *supra* note 7, at 259; AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (The plaintiffs can demonstrate that the directors breached their duty of loyalty by showing that they engaged in self-dealing) (courts will not "evaluate the merits or wisdom of the transaction once it is shown that the decision . . . was made by directors with no financial interest in the transaction adverse to the corporation and that in reaching the decision the directors followed an appropriately deliberative process.").

[372] Rifkind, *supra* note 222, at 112-15,

> The duty of care is an obligation to act on an informed basis after due consideration of all relevant materials, including advice from legal and financial experts, and appropriate deliberation. A plaintiff can demonstrate a director's breach of duty of care by proving that the director's acts rise to the level of gross negligence.

*And see id*. at 120 n.91, *citing Aronson*, 473 A.2d at 812 ("While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.").

[373] *See* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. 1988) (describing the board's fiduciary duties to the shareholders); Revlon, Inc. v. MacAndrews &Forbes Holding, 506 A.2d 173, 179 (Del. 1986).

[374] *See Revlon*, 506 A.2d at 180 *and Aronson*, 473 A.2d at 812.

[375] Plaintiff bears the burden of showing the defects in the directors' decision-making process. *See* Unitrin, 651 A.2d at 1374 ("When the business judgment rule is applied . . . the plaintiff has the initial burden of proof and the ultimate burden of persuasion.").

[376] Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

creditors.[377] By operation of law Israeli courts examine reacquisition of stock under the umbrella of distributions,[378] and focus their attention on ascertaining whether the purpose of the acquisition was a proper or an improper. An attempt to dilute corporate assets for the personal benefit of the directors and/or a controlling shareholder will be struck down.[379]

Israeli law imposes on the directors (and other executives) duties of care and of loyalty.[380] In contrast to Delaware, however, Israel treats a decision to reacquire corporate shares as any other business decision. As such, management is afforded the presumptions of the business judgment rule,[381] and its decisions upheld, whenever it can shown that the challenged decisions fell within management's authority, and were made on an informed basis, in good faith, and in the honest belief that they serve the best interests of the corporation.[382] An informed decision will be one that duly considers the financial disposition of the corporation and its long and short term objectives, as well as, the advise of financial advisers, and, most importantly, the effect it would have on the creditors.[383]

Thus, in general, Delaware and Israeli courts will not interfere with a decision to adopt a stock repurchase plan, absent of a showing that the shares have been caused to be purchased for an improper purpose.[384] Courts are likely to look extra close, however, at

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[377] BAHAT, *supra* note 47, at 444-45.

[378] *See* discussion *infra* p. 30.

[379] BAHAT, *supra* note 47, at 444-45.

[380] GROSS, *supra* note 40, at 345.

[381] *See* id.

[382] *See* i*d*. *See also* ABRAHAM PELMAN, DINEI HAVAROT BE'ISRAEL HALACHA LEMA'ASE [Corporations Law in Israel Concept and Operation] 615 (Hadara Bar-Mor ed., 4th ed. 1994).

[383] GROSS, *supra* note 40, at 345.

[384] DEL. CODE ANN. tit. 8 § 160 statutory notes (2001), *citing* Alcott v. Hyman, 40 Del. Ch. 449, 184 A.2d 90 (1962), *aff'd*, 42 Del. Ch. 233, 208 A.2d 501 (1965). S*ee also* Crane Co. v. Harsco Corp., 511 F. Supp. 294 (D. Del. 1981); GROSS, *supra* note 40, at p.345.

repurchase plans that appear to benefit the insiders unduly, and that appear to be clear self-dealing.

It is further submitted that in the context of share repurchases aggravated by a takeover threat, the business judgment rule does not apply automatically to the conduct of Delaware directors.[385]

Israeli courts have not had the opportunity to consider the application of the business judgment rule in this specific context (considering that buybacks are somewhat of a novelty to Israeli law). Currently, there are no requirements that a repurchase be made equally from each shareholder, nor that corporations announce a private repurchase from all shareholders.[386]

Apparently, until Israeli courts examine buyback in the unique context of takeover threats, the presumption of the business judgment rule will continue to apply just as it does to other managerial decisions. Nonetheless, it is most likely that Israeli courts will consider customizing U.S. methodology on the subject.

Delaware courts have long recognized a potential conflict of interest whenever directors are acting in defense of a hostile takeover.[387] It has become generally accepted, that when introducing anti-takeover defensive measures, target management and the board of directors might be more easily drawn to make decisions based on personal agendas rather than shareholders' welfare. Thus, with respect to challenged anti-takeover

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[385] *See* Unitrin, 651 A.2d at 1372 *citing* Pogostin v. Rice, 480 A.2d 619 (Del. Super. Ct. 1984).

[386] GROSS, *supra* note 40, at 338.

[387] In *Bennett v. Propp*, for instance, the court acknowledged that it "must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved." The court emphasized that "[t]he directors are of necessity confronted with a conflict of interest, and an objective decision is difficult." Bennett v. Propp, 187 A.2d 405 (Del. 1962).

tactics, management must satisfy a two-part enhanced scrutiny test before it may enjoy the presumptions of the business judgment rule,

> Because of the omnipresent specter that a board may be acting primarily in its own interests, 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. Unocal Corp. v. Mesa Petroleum Co. (citation omitted).

*Unocal's* enhanced scrutiny raises the standard of review over managerial decisions, from a rational basis review to a standard of reasonableness.[388] To survive the enhanced scrutiny test, directors must show[389] that, "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed",[390] and that the board action taken in response was "reasonable in relation to the threat posed."[391] Management, or the board, could satisfy the burden (and thus be afforded the protections of the business judgment rule) by showing "good faith and reasonable investigation".[392]

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[388] Rifkind, *supra* note 222, at 121.

[389] The burden of proof is placed on the directors. *Id*. ("Unlike the business judgment rule, which puts the burden of proof on the plaintiff, the *Unocal* test shifts the burden of proof to the directors."); *Paramount*, 637 A.2d at 45 ("The directors have the burden of proving that they were adequately informed and acted reasonably."); DEL. CODE ANN. tit. 8 § 160 statutory notes (2001) ("Where the use of corporate funds to purchase corporate shares will maintain management in control, the burden is on the directors to justify the purchase as one primarily in the corporate interest and not their own. Petty v. Penntech Papers, Inc.(citation omitted).").

[390] This test is known as the "reasonableness test". *See Unocal*, 493 A.2d 946, *restated in* Unitrin, 651 A.2d at 1385-85:

> [A] court applying enhanced judicial scrutiny should be deciding whether the directors made *a reasonable* decision, not *a perfect* decision. If a board selected one of several reasonable alternatives, a court should not second guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.

[391] This test is known as the "proportionality test". *See Unocal*, 493 A.2d at 955. *And see Unocal*, 493 A.2d 946 *restated in* Unitrin, 651 A.2d at 1373.

[392] *Unocal*, 493 A.2d at 955, *quoting* Cheff v. Mathes, 199 A.2d 548, 554-55 (Del. 1964)). *And see* Rifkind, *supra* note 222, at 121 ("A majority of outside directors on the board 'materially enhance[s]' a showing of good faith and reasonable investigation.").

Thus, a decision of a board of directors, comprised of a majority of disinterested and independent directors, which was taken subsequent to considerable investigation would establish a presumption that the business judgment rule applies,

> In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. *Cheff v. Mathes* (citation omitted). However, they satisfy that burden "by showing good faith and reasonable investigation. . . ." (citation omitted). Furthermore, such proof is materially enhanced, as here, by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards. *See Aronson v. Lewis*, (citation omitted); *Puma v. Marriott*, (citation omitted); *Panter v. Marshall Field & Co.*, (citation omitted).[393]

Clearly, insiders may not use defensive measures merely to perpetuate themselves into power,[394] but must have acted out of good-faith intention to protect the corporation. Perceived threats that the court will consider would include threats to corporate policy,[395] as well as threats posed by a stockholder at odds with management.[396] Accordingly, a

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[393] *Unocal*, 493 A.2d at 955.

[394] *See* DEL. CODE ANN. tit. 8 § 160 statutory notes (2001) (*citing Cheff*, 199 A.2d at 554 (1964)) ("if the board has acted solely or primarily because of the desire to perpetuate themselves in office, the use of corporate funds for such purposes is improper."). S*ee also id.* Petty v. Penntech Papers, Inc., Del. Ch., 347 A.2d 140 (1975), *and* Crane Co. v. Harsco Corp., 511 F. Supp. 294 (D. Del. 1981) ("The use of corporate funds to perpetuate control of the corporation is improper, and the burden should be on the directors to justify a stock purchase as one primarily in the corporate interest.").

[395] DEL. CODE ANN. tit. 8 § 160 statutory notes (2001):

> If the purchase of its own stock by the board was motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates the decision was not the wisest course. Cheff v. Mathes (citation omitted).
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> . . .
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> Using corporate funds to purchase corporate stock in order to remove a threat to corporate policy is proper. Unocal Corp. v. Mesa Petro. Co.(citation omitted); Polk v. Good (citation omitted).

[396] DEL. CODE ANN. tit. 8 § 160 statutory notes (2001):

> A reduction of capital through the purchase of shares at private sale is not illegal as a matter of law simply because the purpose or motive of the

stock repurchase motivated by a reasonable belief that the bidder, if successful, will change the business practices of the corporation to the detriment of the corporation's ongoing business and existence, is likely to be upheld. A change reasonably likely to cause harm to the corporation could be a bidder's plan to bust up and liquidate the corporation, or to operate the corporation in an illegal or unethical manner, or that valuable corporate assets might be lost as a result of the bidder coming into control.[397]

In *Unitrin, Inc. v. American General Corp.*,[398] Delaware's Supreme Court reviewed a board's decision to adopt a share repurchase program (in addition to a poison pill rights plan) launched as an attempt to repel an unwanted tender offer. In the course of upholding the board's conduct, the court restated the general rule laid down by *Unocal*, and redefined the proportionality aspect of that test.[399] The court broke down *Unocal's* proportionality requirement into a two-part test. First, requiring a determination of whether the challenged defensive action was "draconian", such that precluded or coerced shareholder choice, and second, if the decision was not draconian, the court would inquire into whether the board's response fell within the range of reasonableness.[400]

In considering the second requirement, that the defensive measure be a response that is reasonable in relation to the threat posed, we draw from *Unitrin's* restatement that

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> purchase is to eliminate a substantial number of shares held by a stockholder at odds with management policy, provided of course that the transaction is clear of any fraud or unfairness. Kors v. Carey (citation omitted).
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> The statutory power granted to corporations to purchase shares of their own stock is subject to abuse, but a thoughtful and honest decision of the board of directors to buy out a stockholder who threatens actual harm to his corporation may be sustained. Propp v. Sadacca (citation omitted).

[397] *E.g.*, valuable corporate contracts that are non-assignable, like special licenses.
[398] 651 A.2d 1361 (Del. 1995).
[399] *Id*. at 1385-91.
[400] *Id*. at 1387-88.

the measure be neither "coercive" nor "preclusive".[401] A defensive action is preclusive, if it prevents stockholders from considering a particular transaction,[402] if it deprives the stockholders of their rights to receive tender offers, or fundamentally restricts proxy contests.[403] Secondly, according to *Unocal's* enhanced business judgment, Delaware

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[401] *Id*.:

> As common law applications of *Unocal's* proportionality standard have evolved, at least two characteristics of draconian defensive measures taken by a board of directors in responding to a threat have been brought into focus through enhanced judicial scrutiny. In the modern takeover lexicon, it is now clear that since *Unocal,* this Court has consistently recognized that defensive measures which are either preclusive or coercive are included within the common law definition of draconian. If a defensive measure is not draconian, however, because it is not either coercive or preclusive, the *Unocal* proportionality test requires the focus of enhanced judicial scrutiny to shift to "the range of reasonableness." *Paramount Communications, Inc. v. QVC Network, Inc*. (citation omitted). Proper and proportionate defensive responses are intended and permitted to thwart perceived threats.

[402] A "preclusive" measure would be one that would frustrate a hostile bid, notwithstanding what the bidder offers. For example, a preclusive poison pill is a repurchase plan, which guarantees the right of each shareholder, but not that of the bidder, to sell back her shares to the corporation at a considerably higher value than their fair market value. Alternatively, the poison pill plan may stipulate the acquisition of the bidder's company shares at a fraction of their fair market value. Delaware courts have had the opportunity to set some baseline principles on identifying preclusive measures. In *Paramount*, the court held that Time's restructured merger with Warner constituted a proportionate response because it did not preclude Paramount from making an offer for the combined company, thus, making the response proportionate. *See Paramount*, 571 A.2d at 1155. Furthermore, in *City Capital Associates v. Interco, Inc*., 551 A.2d 787, 797 (Del. Ch. 1988), Delaware's Court of Chancery defined "preclusive" as an, "action that, as a practical matter, withdraws from the shareholders the option to choose between the offer and the status quo or some other board sponsored alternative." The Court held that Interco's poison pill was disproportionate and preclusive because it deprived shareholder the right to choose between the tender offer and a management's restructuring program. *Id*. at 799.

[403] For instance, in *Moran v. Household International, Inc.,* 500 A.2d 1346, 1357 (Del. 1985) the court held that the poison pill adopted in response to a speculative threat of a hostile takeover was proportionate because it did not strip stockholders of their rights to receive tender offers (because the pill was redeemable upon the directors' decision, and such decision would be subject to scrutiny. id. at 1354) or fundamentally restrict proxy contests. According to the *Unitrin* panel, a proxy contest remains a viable alternative, unless "success would be either mathematically impossible or realistically unattainable." See *Unitrin*, 651 A.2d at 1388-89. Later that year, the District Court of Delaware in *Moore Corp. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1561 (D. Del. 1995) upheld a decision to keep a poison pill in place because doing so would not prevent a proxy contest from succeeding. *And see* Mark Lebovitch & Peter B. Morrison, *Calling A Duck A Duck: Determining The Validity Of Deal Protection Provisions In Merger of Equals Transactions*, 2001 COLUM. BUS. L. REV. 1, 45 (2001):

> For example, when a board adopts a no-talk provision, it prevents itself from communicating with other potential bidders for the company. In doing so, the board makes it less likely that alternative bidders will come forward, thereby reducing the possibility that the stockholders will have alternative deals on

courts will enjoin defensive measures also if they are "coercive". A defensive act is coercive if it is aimed at "cramming down" on the shareholders a management-sponsored alternative,[404] leaving shareholders with no rational choice but to accept the alternative presented by the board.[405]

Mark Lebovitch and Peter Morrison provide a useful example of a coercive action in the context of deal protection provisions,[406]

> [A] coercive Deal Protection may tend to force or compel stockholders to vote for a particular transaction. For example, when a board agrees to an extremely high termination fee tied to a "no" vote, it agrees to pay its merger partner a fixed fee, typically a percentage of the original negotiated deal, if the corporation's stockholders reject the transaction. This device is directly coercive of the stockholder vote because the stockholders know that if they vote against the negotiated transaction, their corporation will automatically be responsible for paying the potential merger partner a significant sum of money. Because they want to avoid the

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> which to vote. Depending on the facts of the case, that Deal Protection may be struck as overly preclusive.

[404] *Unitrin*, 651 A.2d at 1387:

> In *Time*, for example, this Court concluded that the Time board's defensive response was reasonable and proportionate *since it was not aimed at 'cramming down' on its shareholders a management-sponsored alternative*, i.e., *was not coercive*, and because it did not preclude Paramount from making an offer for the combined Time-Warner company, *i.e.,* was not preclusive. *See Paramount Communications, Inc. v. Time, inc.*(citation omitted) (citing for comparison as coercive or preclusive disproportionate responses Mills Acquisition Co. v. Macmillan, Inc. (citation omitted), and AC Acquisitions Corp. v. Anderson, Clayton & Co. (citation omitted). [emphasis added]

[405] *See Unitrin*, 651 A.2d at 1387. For instance, where management response amounts to a waste of corporate assets, either as part of a greenmail transaction coupled with a standstill agreement, or by selling attractive assets at low prices to reduce the attractiveness of the corporation, but at the same time causing irreversible damage to the corporation itself.

[406] Deal protection provisions are contractual provisions, designed to raise the likelihood of completion of first-negotiated deals by making the successful acceptance of a competing bid less likely. Such provisions may include, for example, no-talk, no-shop, required recommendation and/or presentation for vote, termination fee, no termination until a preset date, and cross-option provisions. *See* Lebovitch &Morrison, *supra* note 403.

> significant pay-out, they may tend to vote for the transaction, even if they are not completely satisfied with the deal.[407]

Similarly, "dead hand"[408] and "no hand"[409] provisions in poison pill plans have come under scrutiny for confining the board from redeeming or amending the shareholder rights plan.[410] Such provisions will further have to survive scrutiny under the fiduciary duty standards of *Unocal*[411] and *Blasius Industries v. Atlas Corp*.[412]

It is yet to be seen, whether, and to what extent, Israeli courts tackle defensive share repurchases as a distinctive phenomenon. *Unocal's* enhanced scrutiny standard is an intermediary level of review. It is considered to be, "stricter than the business judgment rule and more deferential than the entire fairness standard".[413] However, it is, "neither a mathematical formula nor an abstract theory, but rather a flexible paradigm courts will apply to the myriad fact scenarios that confront corporate boards."[414] As such, its implementation in Israeli case law should be a daunting task.

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[407] *Id*. at 45.

[408] Dead hand provisions classically take the form of limiting the ability of the continuing directors (directors who were in office at the time the plan was adopted and successors whom they have approved) to amend or redeem the shareholder rights plan. Even if a hostile bidder later becomes successful in replacing a majority of the target's board, the new board would still be unable to redeem or amend the pill for the purpose of allowing the proposed acquisition to proceed.

[409] No-hand provisions are a variation of the dead hand provisions. They have the effect of delaying redemption plans, which might discourage prospective hostile bidders from entering the bidding game.

[410] *See generally*, Peter V. Letsou, Symposium, *Contemporary Issues In the Law Of Business Organizations: Are Dead hand (And No Hand) Poison Pills Really Dead?*, 68 U. CIN. L. REV. 1101 (2000).

[411] Poison pill provision cannot be "preclusive" or "coercive". *Unocal*, 493 A.2d 946.

[412] Poison pill provisions cannot purposely disenfranchise shareholders, absent a compelling motive. Blasius Industries v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

[413] Rifkind, *supra* note 222, at 121.

[414] *Id*.

### iii. Selective Repurchases In Delaware

#### a. Greenmail

The use of selective stock repurchases or greenmail[415] to eliminate the interests of a shareholder at odds with management, has continually been permitted by Delaware courts.[416] The first and leading Delaware case on the legal validity of greenmail, was *Cheff v. Mathes*.[417]

In *Cheff*, a Delaware court found that selective stock repurchases, or greenmail, were proper unless the directors had caused the corporation to repurchase the shares for an improper purpose. The general rule emerging from *Cheff* was that Delaware courts would uphold a transaction, which purpose was to avoid a hostile takeover, where the directors reasonably believes that the hostile takeover could be damaging to the corporation's existence or to important aspects of its business. In such instances, the payment of a premium in return for a standstill agreement (to prevent the hostile takeover) would most likely be upheld, despite the fact that it effectively enriched the bidder at the direct expense of the corporation and its shareholders.

In *Cheff*, the court upheld the payment of greenmail on the ground that the board justifiably feared the hostile bidder's poor reputation as a corporate raider, which had threatened to liquidate the company or materially change its sales policies.[418] The court found that the directors had acted in good faith and upon reasonable investigation in

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[415] "Greenmail is a term that describes a corporation's repurchase of its own stock from one or a small number of shareholders at a premium above market price, thereby eliminating a raider's potential bid for the target corporation, or severing ties with a shareholder that poses a threat to the future policies of the corporation." Eric Bielawski, Note, *Selective Stock Repurchases after Grobow: The Validity of Greenmail under Delaware and Federal Securities Laws*, 15 DEL. J. CORP. L. 95, 95 n.3 (1990).

[416] Macey & McChesney, *supra* note 243, at 23.

[417] 199 A.2d 548 (Del. 1964).

[418] *Unocal*, 493 A.2d at 957.

using corporate funds to buy out a dissident.[419] Interestingly, the size of the greenmail premium above the market value was not a key aspect in *Cheff* and in the cases that followed, except, perhaps, that a very large premium might indicate that the board of directors had been motivated primarily by self-interest.

The standard espoused in *Cheff* was later reaffirmed in *Kaplan v. Goldsamt,*[420]and also endorsed, albeit in dicta, in *Unocal*.[421] In *Unocal*, Mesa Petroleum acquired a large minority block of stock in Unocal. Unocal responded by offering to purchase, at a premium, all outstanding shares to the exclusion of the shares owned by Mesa. The Supreme Court of Delaware upheld Unocal's selective stock repurchases, and endorsed its earlier holdings in *Cheff* and *Kaplan*.[422]

Hence, so far, in the context of hostile takeover defenses, Delaware courts have approved the payment of greenmail as an available defense in thwarting a possible takeover.[423] It is notable, that while the initial burden lies on the board to satisfy *Unocal's* two-prong test, the analysis of the court in *Polk v. Good*[424] appears to suggest that it will be hard to invalidate a greenmail payment under the business judgment rule.[425] In a non-hostile takeover climate,[426] the burden is initially placed on the plaintiffs to plead for the

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[419] *Cheff,* 199 A.2d at 556.

[420] 380 A.2d 556 (Del. Ch. 1977). In *Kaplan*, the plaintiff (stockholder) argued that the corporation paid greenmail in order to avoid a hostile proxy fight that could have led to a change in control. The court stated that the use of greenmail was proper, provided that its purpose was, "to eliminate what appears to be a clear threat to the future business or the existing, successful, business policy of a company." *id*. at 569. The court held, that the board's decision to pay greenmail was protected by the business judgment rule because in making the selective repurchase, the board's sole purpose was not to perpetuate itself in control.

[421] *Unocal*, 493 A.2d 946.

[422] *Id*. at 957.

[423] *Polk*, Del. Supr., 507 A.2d at 537.

[424] Del. Supr., 507 A.2d 531 (1986).

[425] Bielawski, *supra* note 415, at 132.

[426] For instance, in the case of *Grobow v. Perot*, 539 A.2d 180 (Del. 1988), discussed hereafter, a derivative suit was brought by the shareholders on behalf of General Motors (GM), challenging the repurchase of GM's stock from its largest shareholder H. Ross Perot, who was also a member of the GM Board. The complaint alleged, inter alia, that the GM directors breached their fiduciary duties of loyalty

inapplicability of the business judgment rule.[427] It is the plaintiff who is charged with the burden of proving foul purpose or personal motives of the directors.[428]

### b. Exclusionary Repurchases

The two most common ways a corporation can deal selectively in its own stock, are by repurchasing a substantial block of stock from a dissident shareholder, typically at a large premium unavailable to the other shareholders, i.e. greenmail, or by engaging in an exclusionary self-tender offer for the corporation's shares.

A Delaware corporation may decide to conduct an exclusionary self-tender, thereby offering to purchase its shares, usually at a price in excess of the bidder's tender price, in order to eliminate a takeover threat. In an exclusionary self-tender offer, a corporation precludes a bidder, who is attempting a hostile takeover, from tendering his shares into the offer.[429]

In this respect, *Unocal*[430] presents a classic scenario, and the changes that followed it, illustrate the viability of discriminatory self-tender offers as a defensive tactic. In *Unocal*, Mesa, owning thirteen percent of Unocal's outstanding stock, made a two-tiered front-loaded tender offer for thirty-seven percent of Unocal's outstanding stock.[431] The offer indicated that once in control of Unocal, Mesa would buy out the remaining shareholders (through a back-end cash-out merger) using highly subordinated

and due care by paying greenmail, and that the repurchase lacked a valid business purpose. The complaint further alleged that the board's decision was primarily designed for the purpose of entrenching the board members in office.

[427] *Id.* at 189.

[428] Bielawski, *supra* note 415, at 132.

[429] *See, e.g., Unocal*, 493 A.2d at 951. Unocal adopted an exclusionary self-tender offer designed to discourage a hostile bidder and preserve the corporation as a going concern.

[430] *Id*.

[431] *Id*. at 949. Mesa offered $54.00 per share in cash for the shares tendered in the first tier of its offer.

securities, commonly called “junk bonds”.[432] After deciding that Mesa’s tender offer was “inadequate”, Unocal’s board of directors offered the shareholders an alternative self tender,[433] designed to ensure that shareholders who did not tender to Mesa at the front end of the tender offer, would be adequately compensated at the back end of the offer. The board offered to have Unocal repurchase up to forty-nine percent of its shares in exchange for debt securities,[434] in the event that Mesa succeeded with its tender offer. Excluded from participating in this offer was Mesa.[435] Mesa argued that in excluding it from the tender offer, the board violated its fiduciary duty to it as a shareholder.[436]

On these facts, the Supreme Court laid down the standard for examining defensive tactics designed to thwart hostile takeovers. First, in applying *Cheff’s* standard,[437] the defendant directors carried the burden of demonstrating reasonable grounds for believing that a danger to corporate policy and effectiveness existed. The court held that showing good faith and reasonable investigation could satisfy the burden.[438] The second prong of the test, entailed examining the proportionality of the defensive measure employed, in relation to the threat posed.[439] The court stated that such an analysis involves, “the examination of the type of takeover bid, the defensive measure employed, and its effect on the corporate enterprise, including the impact on

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[432] *Id*. at 949-50. The junk bonds had an estimated value of $54.00 per share.
[433] *Id*. at 950-51.
[434] *Id*. at 951. The debt securities that were offered in exchange had an aggregate par value of $72.00 per share.
[435] *Id*.; Laura L. Cox, Comment, *Poison Pills: Recent Developments in Delaware Law*, 58 U. CIN. L. REV. 611, 623 n.73 (1989) (“Including Mesa would have in effect forced Unocal to partially finance Mesa’s tender offer.”).
[436] *Unocal*, 493 A.2d at 953, 957.
[437] *Id.* at 955.
[438] *Id.*
[439] *Id*.

constituents other than the shareholder."[440] The court upheld the share repurchase program, including its exclusion of Mesa, finding that the directors satisfied the burden of showing reasonable ground to believe that Mesa's actions posed a threat on the corporation's welfare (as opposed to posing merely a danger to management positions), and that the board's response was proportional to the threat posed. The court acknowledged that Mesa's offer was coercive and would have forced shareholders to tender their shares at the front-loaded tender offer, out of fear that they will be forced, by Mesa, to later take the inferior junk bonds in the back-end merger. The court found that excluding Mesa from the self-tender offer was thus reasonable because of the inadequacy and coercive nature of Mesa's tender offer.[441]

In response to the Supreme Court's decision in *Unocal*, the Security Exchange Commission (SEC) adopted rule 14d-10,[442] which provides, inter alia, that no bidder shall make a tender offer unless, "[t]he tender offer is open to all security holders of the class of securities subject to the tender offer . . .". Thus, the SEC effectively terminated the viability of exclusionary self-tender offers as a stock repurchase technique.[443] The rule, sometimes termed "all holders" rule, apparently applies to tender offers extended by issuers as well as any other third party bidders.

### c. The Status Of Greenmail After *Unocal*

With the SEC's overruling of exclusionary self-tender offers as valid takeover defenses, the legality of other repurchase practices, which discriminate among shareholders of the same class, was cast into doubt. At present, while *Unocal's*

[440] *See* Bielawski, *supra* note 415, at 101, *citing Unocal*, 493 A.2d at 955.
[441] *Id.*
[442] 17 C.F.R. § 240.14(d)-10 (2001).
[443] Bielawski, *supra* note 415, at 96.

discriminatory share repurchase program would probably be contrary to federal securities laws, it appears that the validity of greenmail as a discriminatory treatment of shareholders (of the same class of stock) will be upheld.

In *Grobow v. Perot*. (1988),[444] the Supreme Court of Delaware approved the payment of a large premium to the corporation's largest shareholder, thereby affirming the validity of a corporation's right to selectively repurchase its shares, and pay greenmail, under Delaware law.[445] In a later suit, brought under the federal securities and Delaware state law, the court upheld the validity of a selective repurchase on facts similar to *Grobow*.[446] In that case, the court refused to classify a repurchase agreement as a tender offer under the Williams Act because the agreement was privately negotiated between parties familiar with the intrinsic value of the stock. As such, the defendant was under no duty to extend the terms of the repurchase to any other shareholder.[447]

#### iv. Selective Repurchases In Israel

##### a. Greenmail

Repurchase transactions involving the payment of greenmail are yet another practice that might call to the close attention of Israeli courts.

Israel, which only recently included in its corporation law the possibility for corporations to repurchase their stock, has not had the opportunity to examine greenmail.

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[444] 539 A.2d 180 (Del. 1988), *aff'd*, 526 A.2d 914 (Del. Ch. 1987).

[445] Bielawski, *supra* note 415, at 97. However, see id. at 130-31 for an analysis of the unique elements in *Grobow*, which are distinguishable from other greenmail related case law. *And see id.* n.214 ("All the cases cited by the [*Grobow*] court involve a different factual setting in which the payment of greenmail is usually justified . . . [these cases are:] *Cheff* (citation omitted) (control premium and threat of liquidation); *Edelman v. Phillips Petroleum Co*. (citation omitted) (control premium and hostile tender threat); *Lewis v. Daum* (citation omitted) (threat to future corporate policy and control premium); *Kaplan* (citation omitted) (threat to corporate control and control premium); *Kors* (citation omitted) (control premium and threat to future business of the company).").

[446] *In re* General Motors Class E Securities Litigation, 694 F. Supp. 1119 (D. Del. 1988).

[447] Bielawski, *supra* note 415, at 133.

It is not likely, however, that Israel will fully adopt Delaware's liberal approach on the matter,[448] though both the Supreme Court of Israel and the legislator continually express the wish to provide a more liberal framework for Israeli corporations to compete in.

At the center of Israeli legal debate, is the question of how much latitude should corporate insiders receive in responding to a control contest.[449] Management is faced with a clear conflict of interest in considering how to react to control threats.[450] They are expected to take action designed to defeat a hostile acquisition of control, because of personal fears that the new controlling party will replace them. Some predominant legal writers claim that this is a sufficient reason to restrict management from taking active steps to trample hostile offers.[451] On the other hand, many provisions in the Companies Law do provide management with leeway in responding to hostile bids, for the purpose of defending shareholders interests.[452] It appears likely that, at least initially, Israeli courts will focus on the objectives behind a managerial decision to pay greenmail, and strike down decisions that are clearly self motivated and unreasonably undermine shareholders' best interests. Thus far, it is widely suggested that, currently, in the context of hostile takeovers, management may respond restrictively, only to protect shareholders interest.[453]

### b. Exclusionary Repurchases

By removing the provisions that prohibited Israeli corporations from repurchasing their own shares, exclusionary self-tender offers may have become a new instrument for

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[448] The statement is the author's personal conviction.
[449] GROSS, *supra* note 40, at 375.
[450] BAHAT, *supra* note 47, at 859.
[451] GROSS, *supra* note 40, at 375. *And see* The Companies Bill, explanatory notes § 375.
[452] GROSS, *supra* note 40, at 368.
[453] *Id*. at 375.

Israeli corporations, in defeating against hostile bids. Thus far, there is no case law or a regulatory scheme to clarify whether exclusionary self-tender offers are a feasible form of defense.

Nonetheless, Chapter II of the Companies Law provides that where, as a result of the acquisition, the acquirer is expected to realize control over the firm[454] or is expected to raise his holdings beyond a 45% threshold,[455] the acquisition must be preceded by a "special" tender offer. The rules pertaining tender offers are outlined, in general, in the Securities Regulations (Tender Offers), 2000,[456] however, no particular reference is made to exclusionary self-tender offers per se.

Because tender offers are recognized as a feasible cause of tension for corporate management,[457] management's ability to influence the effectiveness of a pending tender offer is limited, through legislation, primarily, to providing an opinion on the quality of the offer and to conducting negotiations with the offeror and/or alternative buyers.[458]

Prior to the Companies Law and the Securities Regulations, tender offers were a poorly regulated subject matter. The Companies Ordinance, a derivative of the English Companies Act, was lacking a regulatory framework on tender offers. This in turn promulgated much case law with respect to third party tender offers.[459] At present, the Companies Law, and the supplementary regulations of the Securities Act,[460] provide a more comprehensive structure for tender offers.

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[454] Twenty-five percent, where there is no controlling shareholder

[455] Providing that no other shareholder holds more than 50% of the firm's voting power.

[456] Securities Regulations (Tender Offers), 2000 (hereinafter Securities Regulations, 2000).

[457] A pending offer for the purchase of control may pose a threat to the continuation of the existing board.

[458] The Companies Law, 1999, 330 S.H. 189.

[459] For tender offers prior to the Companies Law see C.C. (T.A.) 201117/98, Meshulam Levinstein & Saul Lotan v. Edgar Investments and Development (1998); GROSS, *supra* note 40, at 366-82; BAHAT, *supra* note 47, at 828-66.

[460] The Securities Regulations, 2000.

One of the items that the legislator addressed in the new securities regulations and the Companies Law was the need to protect the rights of public shareholders in acquisitions of large stakes, which are conducted beyond the scope of market pressures.[461] In order to level the playing field, and to make the shareholders effectively alert to offers that might result in a change of control,[462] the practice of creeping acquisitions[463] was eliminated.[464] By making the shareholders aware of a possible control struggle, shareholders were given the opportunity to demand appropriate control premiums for their stock.[465] In addition, members of management were made accountable to the bidder and the offerees, for actions taken with the purpose of trampling current or foreseeable special tender offers. In defense of their actions, management could demonstrate that they have acted upon the good faith belief that such actions were warranted in the best interest of the corporation.[466]

Section 5 of the Securities Regulations[467] provides that tender offers must be made equally to all the security holders of the class of securities that is subject to the offer. Section 5 resembles in this respect rule 14d-10 of the SEC, in that it apparently sets aside exclusionary self-tender offers.

Though it is not discussed in legal literature, it is possible, (no evidence pointing to the contrary) that this rule applies equivalently to tender offers extended by issuers.

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[461] The Companies Law, 1999, explanatory notes.
[462] The Companies Bill, explanatory notes, Chapter 5, part 9.
[463] A series of continuous small acquisitions, that ultimately secures control for the acquirer.
[464] The Companies Law, 1999, 328 S.H. 189.
[465] BAHAT, *supra* note 47, at 854.
[466] The Companies Law, 1999, 330 S.H. 189. *See also* BAHAT, *supra* note 47, at 859.
[467] The Securities Regulations, 2000.

# CHAPTER 7

## LIABILITY FOR IMPROPER DISTRIBUTIONS

Under both Delaware and Israeli law, director liability on account of an improper repurchase is similar to that imposed for an improper dividend. The board of directors and/or the shareholders may be accountable for restitution to either the corporation or directly to the creditors. Furthermore, both jurisdictions will most likely hold directors personally liable under the more general duties of good faith and loyalty, for knowingly approving an improper distribution.

The directors of a Delaware corporation are subject to joint and individual liability,[468] for willful or negligent, unlawful distributions.[469] However, a director may be exonerated from such liability, if he or she expressly dissented the distribution,[470] and if he or she relied,

> [I]n good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of its officers or . . . by any other person

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[468] DEL. CODE ANN. tit. 8 § 172 statutory notes (2001) ("This section contemplates the recovery and restoration to the capital of the corporation, of the entire amount thus illegally withdrawn; and to that end each director is made individually liable for such amount. John A. Roebling's Sons Co. ex rel. Whitley v. Mode (citation omitted).").

[469] DEL. CODE ANN. tit. 8 § 174 (2001). *See generally* Roberts & Pivnick, *supra* note 147, at 67. *And see id*. § 174 statutory notes (for the scope of this section):

> This section imposes liability for unlawful distributions and dividend payments in addition to restricting purchase of a corporation's own shares of capital stock; company's financing of leverage buyout transactions may properly be treated as an unlawful dividend payment or distribution from company to its parent company and sole shareholder. Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (citation omitted).

[470] DEL. CODE ANN. tit. 8 § 174(a) (2001).

> as to matters the director reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation, as to the value and amount of the assets, liabilities and/or net profits of the corporation or any other facts pertinent to the existence of surplus or other funds from which dividends might properly be declared and paid, or with which the corporation's stock might properly be purchased or redeemed.[471]

Once it is established that an unlawful distribution occurred, every shareholder is compelled to return to the corporation that which he received, unless the shareholder did not know, and should not have known (objectively), that the distribution was unlawful.[472] In examining foul play, the shareholders of Israeli public corporations enjoy a presumption of "ignorance", provided that they were not in the position of a controlling shareholder, director, or chief executive, at the time of distribution.[473]

An unlawful distribution, plainly implicates the directors of an Israeli corporation.[474] Directors, who fail to demonstrate one of the following alternatives, will be regarded as having breached their duty of loyalty.[475] The directors must show that they either opposed the decision to make the distribution and had taken all reasonable measures to prevent it,[476] or that they did not know, and under the circumstances could not have known, that the distribution was improper.[477] The directors may claim that they

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[471] *Id*. § 172. *See also* Klang, v. Smith's Food & Drug Centers, 1997 Del. Ch. LEXIS 73, *16, Del. Ch., C.A. No. 15012, Chandler, V.C. (May 13, 1997), *and* Aronson v. Lewis, Del. Supr., 473 A.2d 805, 812 (1984), Smith v. Van Gorkom, Del. Supr., 488 A.2d 858 (1985) (for the proposition that only if the decision making process is grossly negligent may liability for damages, resulting from a good faith decision, be found).

[472] The Companies Law, 1999, 310 S.H. 189.

[473] *Id*. § 310(b).

[474] *Id*. §§ 254-57.

[475] *Id*. §311. *See also* 1 URIEL PROCACCIA, HOK HAVAROT HADASH BE'ISRAEL [New Corporations Law in Israel], 517-22 (1994).

[476] The Companies Law, 1999, 311 S.H. 189. The scope of this principle is unclear. Existing case law is helpful in evaluating the gravity of this principle as an alternative. *See* C.C. (Jm.) 400/89, Official Receiver for North America Bank Ltd., Liquidator v. Zusman & Others, P.M. 3(2) (1984); GROSS, *supra* note 40, at 357.

[477] *Id*. § 311(b).

reasonably relied, in good faith, on inaccurate information when lending their approval, however, they will need to demonstrate that had the information they relied upon been correct, the distribution would have been proper.[478]

Under Delaware law, directors that approve an unlawful distribution are entitled to be subrogated to the rights of the corporation, against stockholders who accept the proceeds of a distribution with knowledge of facts that indicate illegality.[479]

An exception, unique to Israeli law,[480] authorizes creditors to submit a derivative claim against the corporation for an unlawful distribution.[481] Being derivative, however, it is the corporation, and not the creditors, that will enjoy its fruits, despite the fact that it was the creditors who brought the action. The burden of proof remains, nonetheless, on the shoulders of the creditors to show that the distribution had rendered the corporation unable to pay its debts.[482]

An important implication in associating unlawful distributions with a breach of duty of loyalty (as opposed to duty of care), is that directors cannot purchase insurance against breach of loyalty.[483] In terms of indemnification, section 261 of the Companies Law restricts indemnification to instances where the director proceeded in good faith belief that he or she was acting in the best interest of the corporation.[484]

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[478] The Companies Law, 1999, 311(c) S.H. 189.

[479] DEL. CODE ANN. tit. 8 § 174(b), (c) (2001). On stockholders liability for unlawful distributions see generally, Norwood P. Beveridge, Jr., *Does a Corporation's Board of Directors Owe a Fiduciary Duty to Its Creditors?*, 25 ST. MARY'S L.J. 589, 610 (1994).

[480] *See* Cohen, *Directors' Negligence Liability to Creditors*, *supra* note 339. In contrast, Delaware creditors have a right of action against the corporation only in the context of insolvency. DEL. CODE ANN. tit. 8 § 174 (2001).

[481] The Companies Law 1999, 204, S.H. 189.

[482] GROSS, *supra* note 40, at 356.

[483] The Companies Law, 1999, 258(a) S.H. 189. Insurance is available, however, for breaches of duty of care. *See id*. § 258(b).

[484] *Id*. § 261(2).

Following substantial criticism by the legal community, the Justice Department of Israel rewrote section 311 of the Companies Law. In a recent amendment, pending parliament's approval, it was suggested that the burden placed on directors with respect to improper distributions be moderated. It is recommended that the provision, which relates a breach of duty of loyalty to unlawful distributions, be replaced with a provision that associates unlawful distributions to a general breach of duty. The first implication of this amendment, if approved, will be to empower the courts to determine whether the distribution represents a breach of duty of loyalty or a breach of duty of care. The second implication is that Israeli corporations could purchase insurance for unlawful distributions resulting from breach of duty of care.

It is further recommended that Israeli corporation law continue to make it impossible for corporations to excuse directors, in advance, for distributions resulting from a breach of duty of care. The rationale being that renouncing the right to collect capital that is duly payable to the corporation (as a result of an unlawful distribution), will unduly injure the creditors of the corporation.[485]

In comparison, Delaware generally authorizes corporations to write into the articles of incorporation a provision that reduces or eliminates the financial responsibility of the creditors. However, such indemnification or exculpation provision does not have the power to excuse unlawful behavior and breaches of loyalty,[486] including acts or omissions not in good faith, or which involve a knowing violation of

[485] The Companies Law Memorandum (2001), The State of Israel Ministry of Justice, *available at* http://www.justice.gov.il/legal/tazkir/tazkir.htm

[486] DEL. CODE ANN. tit. 8 § 102(b)(7) (2001).

law, unlawful dividends or stock repurchases, and transactions in which the directors derive a personal benefit.[487]

[487] Sandra Miller, *Piercing the Corporate Veil Among Affiliated Companies in the European Community and in the U.S.: A Comparative Analysis of U.S., German, and U.K. Veil Piercing Approaches*, 36 AM. BUS. L.J. 73 (1998).

# CHAPTER 8

## CONCLUSION

This thesis demonstrates how the distribution of dividends and the acquisition by a corporation of its own stock may translate into a direct transfer of value from creditors to shareholders.

Because equity owners are generally not accountable for liabilities exceeding their investment, without the constraints of the law they could escape the burden of debt by paying out the corporation's assets in the form of dividends, or through the reacquisition of stock.[488] It is suggested that creditors have a legitimate concern that the shareholders of leveraged corporations, and managers as well, in certain circumstances, might cause the corporation to undertake riskier investments than would be optimal for a non-leveraged corporation, especially when the corporation is approaching insolvency. In the absence of a special agreement with the corporation, the disposition of individual creditors is adversely affected by distributions of assets and increases in the aggregate of outstanding claims against the corporation.

Though the equity cushion is a recurring theme in the legal capital model, it is widely suggested that it provides no significant protection to creditors. In fact, statutory provisions that allow reduction surpluses and revaluation surpluses, effectively castrate the restrictions placed on distributions. Furthermore, the legal capital rules never prevented the erosion of corporate assets nor did they prevent the incurrence of

[488] *See* discussion *infra* part 2.I-II.

additional, possibly secured or senior, corporate debt. The ease with which stated capital could be reclassified as surplus, suggests that legal capital presents no real obstacle to distributions.

Critics maintain that creditors have better means to protect their interests.[489] It is suggested that debtholders anticipate and estimate risk-increasing behavior prior to advancing loans to the corporation. Assuming this presumption is well-founded, creditors are in a position to demand, among other things, an interest rate commensurate to the risk that they anticipate, and write restrictive covenants into the debt agreement to inhibit the corporation from assuming risky projects. If the creditors indeed have better means to protect their interests, then perhaps the added strain that the legal capital model imposes on corporations is overprotective of creditors and unreasonably interferes with the corporation's autonomy.

Dividends and share repurchases may be central considerations for prospective investors.[490] They may become an important component in the appreciation of risk, particularly with respect to high-risk investments, where the corporation's ability to increase its earnings is uncertain. In distributing wealth to the shareholders, those risks may be gradually downgraded. Furthermore, if investors actually regard distributions as a signaling function of the firm's potential, the ability of corporate insiders to transmit messages via the stock market may prove crucial in certain circumstances.

Distributions may play a central role in the corporation's financial strategy. They may have the effect of raising earnings per share, rewarding non-selling shareholders of undervalued stock, reducing aggregate dividends and other shareholder servicing costs,

[489] *See* discussion *infra* part 4.
[490] *See* discussion *infra* part 5.

satisfying stock options (without diluting earnings per share), or eliminating fractional shares. Other business purposes may include manipulating stock value, tax incentives, or even as a device for reducing the issuer's vulnerability to unsolicited acquisitions and defeating unwanted takeover bids.

Nevertheless, despite the multiple benefits that repurchase plans and dividends present, critics often discard them for being used to purposely manipulate stock prices. The market crisis that Israel experienced in 1983 is a classic illustration of the weight of such concerns.

The corporation codes of Israel and Delaware shared little resemblance before 1999, despite the fact that both legal systems were originally the product of nineteenth century English law. The introduction of the new Companies Law symbols a shift towards the liberalization of commercial law in Israel. The deletion of some hard-line restrictions on share repurchases and the adoption of a nimble dividends provision, were both vital changes, especially suitable for the survival of some corporations in the down sloping economy. However, many provisions in the Companies Law pertaining distributions, remained particularly inflexible as compared with parallel laws elsewhere.[491]

Despite efforts to modernize the Israeli corporation code and to make it competitive with other popular foreign jurisdictions, Delaware remains a more promising destination. The Delaware code continues to surpass Israel in its flexibility and broad approach to distributions. For one thing, while both jurisdictions stipulate that distributions be made out of profits and surpluses, Delaware's G.C.L. deems the entire

[491] *See* discussion *infra* parts 3.III, 6.II.

surplus, earned or unearned, including paid-in surpluses, as viable sources for that purpose. In contrast, under Israeli law, distributions may only be made out of the retained earnings account, forbidding distributions from any and all stock capital regardless of its designation.

Above and beyond the retained earnings test, the new Companies Law poses an additional test of insolvency.[492] The insolvency test essentially bans distributions that raise reasonable concerns that they might hinder the corporation's ability to meet existing and anticipated liabilities. However, what is a reasonable concern and what does "being able to meet" mean? What exactly are "anticipated liabilities"? The new Companies Law resorts extensively to concepts which boundaries have yet to be determined. This leaves much leeway for court intervention, and very little certainty for the parties affected by it. Until the courts construe these notions, there is no estimating their precise legal import.

Regarding director's liability for improper distributions,[493] it is generally accepted, both under Israeli and Delaware law, that the directors of a *solvent* corporation do not owe the creditors any duty other than duties arising with respect to compliance with the terms of the debt. However, the import of the insolvency test into the Israeli formula for distributions, may have introduced far-reaching consequences to which Israeli directors are not yet aware of. While it remains uncertain whether and to what extent directors owe a duty to creditors while the corporation is solvent, it is clear that a special duty exists once the corporation enters insolvency.

It is likely that Israeli courts will consider the line that Delaware courts have taken on this topic. Before *Credit Lyonnais*, Delaware case law clearly proposed that while the

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[492] *See* discussion *infra* parts 6.II.iii.
[493] *See* discussion *infra* part 7.

corporation was solvent, directors were released of all but their contractual duties to bondholders. Once insolvency in fact occurred, then per *Geyer*, directors owed fiduciary duties to the creditors. In *Credit Lyonnais*, however, the Delaware Court of Chancery suggested that fiduciary duties materialize, at the vicinity of insolvency, to a community of interest that is larger than that earlier identified. *Credit Lyonnais* has left a trail of uncertain issues including, what is the trigger mechanism at which a corporation enters the vicinity of insolvency. What is the breadth of the community of interests that directors need to consider, and what is the scope of the duty to them?

In the context of defensive actions aggravated by a takeover threat,[494] Delaware courts have long recognized that a potential conflict of interest between directors and other constituencies, necessitates that the business judgment rule will not automatically apply to the conduct of Delaware directors. Israeli courts have not yet had the opportunity to consider the application of the business judgment rule in this specific context and, thus, continue to apply the presumptions of the business judgment rule as to any other business decision. It is likely that when Israeli courts tackle defensive share repurchases as a distinctive phenomenon, they will consider customizing U.S. methodology on the subject. Nevertheless, the legitimacy of poison pill redemption plans in Israel is doubtful even after the Companies Law. The validity of greenmail is yet to be examined, having that share repurchase is a novelty in itself. Thus, until Israeli courts address this question, it may be that redemptions plans and transactions involving greenmail that are intended to thwart hostile bids, will be carefully scrutinized under the general requirements for distributions. Delaware courts are expected to uphold redemption plans, whose purpose is

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[494] *See* discussion *infra* parts 6.III.ii-iv.

to avoid a hostile takeover that could be potentially damaging to the corporation, as well as transactions involving the payment of greenmail under the same circumstances. The validity of exclusionary self-tender offers, however, appears to have been ousted in both Delaware and in Israel.

Finally, both jurisdictions hold directors personally liable, under the more general duties of good faith and loyalty, for knowingly approving an improper distribution.[495] The directors of both Delaware and Israeli corporations will be liable for a willful or negligent unlawful distributions. They may be exonerated from such liability, if he or she expressly dissented the distribution, or relied on inaccurate information in good faith. However, currently, Israeli directors may be liable for breach of duty of loyalty in instances where their approval was negligent. Unless Israeli legislators amend the Companies Law to associate improper distributions with a general duty to the corporation, as opposed to a strict duty of loyalty, Israeli directors will continue to bear an exceptionally heavy burden.

Seeing as the availability of distributions is a main consideration weighing with investors as they decide where to put their money and where to set up their business, over-restrictive provisions may operate to the detriment jurisdictions that seek to become competitive, like Israel. The new Companies Law inclines partly toward full market freedom, and partly toward paternalism. It apparently disregards the latter-day fact that market forces may have the ability to balance asymmetries in power between the bondholders and the corporation, making legislative intervention in itself a disruptive element.

[495] *See* discussion *infra* part 7.

Israel's new Companies Law, even if it has the pretensions of being the most equitable, is also very innovative and unique. As such, it is also less clear, less simple, less user-friendly, and the business arrangements it calls for are loaded with uncertainties. In a global competitive market that is ultimately dominated by systems of easiest, clearest, simplest, and most worthwhile laws[496] governing economics, securities, tax and companies, Israel might continue to lose out in favor of other jurisdictions, particularly Delaware.

[496] Not the most moral and the most equitable.

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