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The North Carolina Shareholder Protection Act

In the wake of the 1987 stock market crash, the famed and feared Predator Corporation surveys the scene. Predator is known for taking over undervalued companies and selling off their assets at a tidy profit. This looks like a good time for a merger, because the companies Predator is eyeing have experienced a sharp drop in their share prices.[1]

Predator's cool and ruthless gaze soon fixes on Lamb Industries. Predator approaches the Lamb Board of Directors with a merger proposal, but the Lamb directors, who know a threat when they see one, send Predator on his way.

Predator, however, is not to be put off so easily. If it cannot entice a merger agreement out of Lamb, it has the cash to buy one. It can make a two-tier tender offer, purchasing fifty-one percent of Lamb's shares in the first tier, with the idea that it will become the controlling shareholder in the company and can then, in the second tier, elect a Board that will recommend shareholder approval of the merger. As majority shareholder, Predator can also approve the merger.[2]

Predator's two-tier takeover plan provides a distinct advantage for a suitor corporation, allowing it to buy the votes it needs for a merger in the first tier. It will have to pay a premium for these shares, because they transfer control, but when the bidder is in a position to approve a merger, it can buy out the remaining shareholders at a lower price and recover the premium.[3] The two-tier approach, however, has distinct dangers for shareholders: although the shareholders who sell their shares to the acquiring company in the first tier will profit because they receive part of the control premium,[4] the shareholders who

1. *See Companies Take Over the Takeover Game from Flashy Raiders*, Wall St. J., Jan. 25, 1988, at 1, col. 6 (hostile corporate takeover bids spurred by low prices resulting from market crash). *But see* E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 2 (1973) ("Perhaps the most important factor in assessing the vulnerability of a particular company is the price/earnings ('p/e') ratio of its common stock.").

2. Finkelstein, *Antitakeover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions under Delaware Law*, 11 SEC. REG. L. J. 289, 293 (1984); Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 330-31 (1974).

3. A two-tier offer with a higher first-step price and lower second-step price is also called a front-end loaded offer.

How much should Predator offer per share in his tender offer? Lamb shares are now selling for $15 per share, and there are 300,000 shares outstanding. Fifteen dollars per share is a good price, so Predator is willing to pay $4.5 million for the company. Because Predator only wants 51% of Lamb, it should offer $15 per share for 150,001 shares, or $2,250,015.

But those 150,001 shares are worth more than $15 per share, since they will transfer control. So Predator could offer $17, for a total tender offer of $2,550,017. Does this mean that he will have to pay more than his budgeted $4.5 million for Lamb? Not if he can later buy out the remaining shareholders for less than $15 per share. Predator figures he can do this, since he will be in a position, as controlling shareholder, to approve a subsequent merger between Predator and Lamb on his own terms. Predator will offer $13 per share to the minority shareholders in a merger proposal, and Predator, as majority shareholder, will approve. Even though Predator had to pay a premium for the first 51% of the shares, it can make up the difference once it is calling the shots.

4. The debate over a shareholder's right to retain the premium he receives for sale of control has generated a large volume of commentary. Brudney & Chirelstein, *supra* note 2, at 334. Case law suggests that courts will allow a shareholder to retain the premium unless it reflects the price paid for a specific corporate asset corresponding to control. In Perlman v. Feldmann, 219 F.2d 173 (2d

sell in the second tier will not share in the profit, and any protest will be ineffectual[5] because the acquirer controls the company.[6] In response to the danger of unfair treatment of minority shareholders in a two-tier takeover, Congress and the Securities Exchange Commission have explored the possibility of protecting shareholders,[7] and some states have enacted statutes mandating fair treatment of minority shareholders.[8]

The North Carolina Shareholder Protection Act (the Act)[9] was ratified in 1987 in response to the attempted takeover of Burlington Industries, a Delaware Corporation with less than half of its employees and assets in North Carolina.[10] The General Assembly passed the Act with remarkable speed and without hearings.[11] As a result, the bill did not receive the attention it otherwise might have, and both the operation and significance of many of its provisions are unclear. In addition, although its title proclaims an interest in protecting shareholders, and its provisions dictate various formulas for determining a fair price in a two-tier takeover, the Act had the immediate aim of forestalling the Burlington Industries takeover.[12] The unsurprising result is that the Act is as much an antitakeover act as it is a shareholder protection act.

This Note outlines the state and federal protections provided for shareholders in two-tier takeovers before the passage of the Act, indicating the inadequacies that have led to the need for further protective legislation. It then plots how

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Cir. 1955), a rare case in which the court was willing to tie a premium to a specific asset, the shareholders were not allowed to retain the premium. In that case a purchaser bought a controlling interest in a steel company in order to assure himself a steady supply of steel during the Korean War, when steel was rationed. *Id.* at 178. The court reasoned that the premium purchased more than general control of the steel company. In addition it purchased a supply of steel the purchaser could not have obtained otherwise. *Id.*

5. *See infra* notes 15-20 and accompanying text for discussion of traditional shareholder remedies in this situation.

6. Because of the possibility of this result, shareholders are likely to be stampeded into tendering their shares when a partial tender offer is made, for fear of losing out in the second tier. They are likely to tender even if they are unsatisfied with the price if they believe the tender offer will be successful.

7. *See* Tender Offer Reform Act of 1987, 100th Cong., 1st Sess. 1987; SEC ADVISORY COMMITTEE ON TENDER OFFERS, Fed. Sec. L. Rep. (CCH) No. 1028, Extra Edition July 15, 1983. Both the proposed legislation and the SEC Advisory Committee report adhere to the basic neutrality of the Williams Act as discussed *infra* note 27 and accompanying text. *See* Advisory Committee Report, *id.* at 9; 197 N.Y.L.J., Feb. 19, 1987, at 1, 2 ("actual legislation is likely to be limited to marginal changes in the Williams Act and fundamental decisions will be left to the SEC, state legislatures and the marketplace.").

8. *E.g.*, ILL. ANN. STAT. ch. 32 para. 7.85 (Smith-Hurd Supp. 1986); IND. CODE ANN. § 23-1-43 (Burns Supp. 1987); MD. CORPS & ASS'NS CODE §§ 3-602, 3-603 (1985 & Supp. 1986).

9. An Act to Amend the Business Corporation Act to Provide for the Protection of Public Shareholders of North Carolina Organized Corporations from being Coerced by Certain Business Combination Practices and to be Designated the North Carolina Shareholder Protection Act, ch. 88, 1987 N.C. Sess. Laws 70 (codified at N.C. GEN. STAT. §§ 55-75 to -80 (Cum. Supp. 1987)).

10. Other states enacting takeover statutes "at the direct request of large local companies threatened by outside takeovers" include Minnesota, Massachusetts, Washington, Wisconsin and Arizona. Welch, *States Checkmate Corporate Raiders*, ST. LEGISLATURES (Jan. 1988) 14.

11. Hazen, *State Antitakeover Legislation—The Second and Third Generations*, 23 WAKE FOREST L. REV. 77, 79 n.12 (1988).

12. *See* An Act to Amend the North Carolina Shareholder Protection Act, ch. 124, 1987 N.C. Sess. Laws 1. The Preamble to this Act, which brought Burlington Industries under the purview of the Shareholder Protection Act, speaks of the purpose of the act entirely in terms of protecting the state and local tax bases, employees, and unrelated businesses in the state. *Id.* at 1.

the Act works, noting certain ambiguities in the Act's requirements and the implications of the various provisions for determining the prices to be paid shareholders for their shares. Finally, the Note shows that even though the individual provisions of the Act have the ostensible purpose and effect of protecting shareholders, the most important requirements are carefully constructed to frustrate takeovers. First, the Act undermines the strategy underlying the two-tier takeover. Second, it neutralizes one of the leading motives for a merger, the benefit to a purchaser of acquiring a company with a low price/earnings ratio.[13] The Note concludes by urging recognition that the Act does not merely regulate takeovers, but severely inhibits them. The General Assembly may decide that virtual prohibition is the approach it wants to take, but it has yet to give this exceedingly complex issue the kind of attention and calm deliberation it requires.[14]

State corporation laws have traditionally recognized that shareholder interests are fundamentally implicated in a merger and must be protected. The law has provided such protection by providing for shareholder ratification of mergers[15] and, for shareholders who dissent from the merger, the right to receive "fair value" for their shares.[16] In the context of the front-end loaded two-tier takeover, however, these protections lose their effectiveness. Shareholder ratification of a merger is meaningless if the suitor company controls enough votes to ensure approval. But even when the suitor has not purchased the statutorily required number of shares to guarantee approval, the suitor who controls the board of directors has control of the proxy machinery and can use proxy solicitations to marshal a disproportional number of votes. As a result, "the ability of the stockholders to exercise their voting rights with real effect . . . is slight."[17]

The appraisal remedy for dissenting shareholders is likewise inadequate to protect the minority shareholder when a two-tier takeover forces an unwanted merger on them. Shareholders dissent because they believe the terms of a merger are not as favorable as they would like. In a cash-out merger, in which the majority purchases all shares from public shareholders, they will have to accept whatever terms are approved by the controlling shareholder or resort to the

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13. The price/earnings ratio is the price per share divided by earnings per share.

14. This Note will not address the constitutionality of the Act, though that is an issue deserving of attention. The General Assembly apparently recognized the difficulty when it included two provisions that serve only to protect the Act against invalidation under a constitutional challenge.

Section 55-79.1, entitled "Conflict of laws," limits the extraterritorial applicability of the Act:

> If any jurisdiction under the laws of which a foreign corporation is organized adopts any law containing provisions that are expressly inconsistent with the provisions of this Article as applicable to such foreign corporation, the provisions of this Article shall be inapplicable to such foreign corporation to the extent necessary to resolve such inconsistency.

Id.

Section 55-80, entitled "Severability," provides that any provision in the Act declared invalid will be deemed severable from the remainder of the Act if the Act "can be given effect without the invalid provision. . . ." *Id.*

15. *E.g.*, DEL. STAT. ANN. § 251(c) (1987); N.C. GEN. STAT. § 55-108(b) (1982); REVISED MODEL BUSINESS CORPORATION ACT § 11.03(b)(2) (1984).

16. *E.g.*, N.C. GEN. STAT. § 55-113(b) (1982).

17. Brudney & Chirelstein, *supra* note 2, at 300. The SEC Advisory Committee Report, *supra* note 7, at 23, estimates that 20% share ownership is sufficient to confer control.

appraisal remedy. As Professors Brudney and Chirelstein note, "the object of appraisal is to give dissident stockholders an opportunity to avoid the consequences of merger, not to undo the merger or to press directly for better terms."[18] Shareholders may well desire not to be in the position they were in before, which is where the appraisal remedy will attempt to place them,[19] but to be in a position in which they can share fully in the gains resulting from the merger.[20] Thus, neither of the traditional protections for shareholders in the statutory merger context is adequate in a two-tier takeover.

Since 1968, when Congress enacted the Williams Act,[21] federal securities regulation has provided additional protection for investors by requiring anyone seeking to take control of a public issue corporation to disclose his plans,[22] and also by prescribing a timetable for a tender offer that provides sufficient time for the investor to make a reasoned judgment about the offer.[23] In addition, tendering shareholders may withdraw their shares at any time during the first fifteen days the offer is effective,[24] all shareholders must be paid the same price for their shares,[25] and the offeror must purchase shares pro rata from all shareholders if more shares are tendered than the offeror has offered to purchase.[26]

The Williams Act proceeded on the theory that takeovers might be either good or bad, depending on their terms, and its regulations sought to be neutral, neither encouraging nor impeding takeovers.[27] The states, however, soon followed with what has come to be known as the "first generation" of takeover statutes.[28] These statutes abandoned the neutral stance of the Williams Act and instead gave corporate management the weapons to defeat tender offers whether they were in the best interests of the shareholders or not.[29] The first-generation statutes address the front end of the two-tier takeover, generally imposing a

18. Brudney & Chirelstein, *supra* note 2, at 304.

19. Brudney & Chirelstein, *supra* note 2, at 306. *But see* Weinberger v. UOP, 457 A.2d 701, 704 (Del. 1983). This case says that appraisal must include all relevant factors in determining value of shares, though it is not clear whether such factors could include forecasts of future gains resulting from the merger.

20. Brudney & Chirelstein, *supra* note 2, at 305.

21. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d), (e), 78n(d), (e), (f) (1982)). The United States Supreme Court discussed the legislative history of the Act, finding that it shows the basic purpose of the act to be protection of investors, in Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 28-38 (1977).

22. 15 U.S.C.A. § 78m(d)(1)(West 1981).

23. The offer must remain open for 20 days. 17 C.F.R. § 240.14e-1 (1987).

24. 17 C.F.R. § 240.14d-7(a)(1) (1981).

25. 15 U.S.C.A. § 78n(d)(7) (West 1981).

26. 15 U.S.C.A. § 78n(d)(6) (West 1981).

27. Edgar v. MITE Corp., 457 U.S. 624, 633 (1982); Aranow & Einhorn, *State Securities Regulation of Tender Offers*, 46 N.Y.U. L. REV. 767, 768 (1971); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 253 (1983).

28. The Williams Act amendments to the Securities Exchange Act of 1934 left the following provision intact: "Nothing in this chapter shall affect the jurisdiction . . . of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder." 15 U.S.C. § 78bb(a) (1981). This leaves open to the states the option of passing laws regulating takeovers. *Edgar*, 457 U.S. at 631.

29. Aranow & Einhorn, *supra* note 27, at 785. "Thinly disguised as legislation for the protection of investors, these statutes cannot in any practical sense be viewed as anything more than attempts to protect incumbent management and local industry." *Id.*

waiting period between the announcement of the tender offer and the effective date. According to Aranow and Einhorn, such a requirement "effectively eliminates one of the major advantages of the tender offer technique—that of surprise."[30]

North Carolina participated in the first generation with the Tender Offer Disclosure Act, enacted in 1977.[31] This statute, applying to North Carolina corporations and to companies having their principal place of business and substantial assets in the state,[32] requires that tender offers remain open for twenty-one days,[33] and that tendering shareholders be allowed to withdraw their shares "at any time up to three business days before the termination of the effectiveness of the tender offer."[34] The act also requires disclosure of pertinent information about the offeror, including the source of funding for the offer and a "statement of the purpose . . . of the tender offer and of any plans existing at the time such tender offer is made. . . ."[35]

The state schemes were thrown into disarray when the United States Supreme Court declared an Illinois first-generation takeover statute unconstitutional in *Edgar v. MITE Corp.*[36] The Court held that the Illinois statute "upset the careful balance struck by Congress" in the Williams Act between target company and bidder.[37] North Carolina's first-generation statute, comparable to the Illinois statute struck down in *Edgar*, has never been tested, but one commentator has argued that it is probably unconstitutional under the analysis in

30. Aranow & Einhorn, *supra* note 27, at 775. The waiting period allows the target company to communicate with its shareholders before the acquirer can present its case. It may also give time for the company to offer to purchase its own shares. *Edgar*, 457 U.S. at 638 n.13 (listing defense strategies capitalizing on delay of tender offer).

31. An Act to Create a New Chapter 78B Concerning Tender Offers, ch. 781, 1977 N.C. Sess. Laws 1018 (codified in scattered sections N.C. GEN. STAT. §§ 78B-1 (1985)).

32. *Id.* § 78B-2(12) (defining "Subject company").

33. *Id.* § 78B-3(1).

34. *Id.*

35. *Id.* § 78B-4(4).

36. 457 U.S. 624 (1982). Recently, however, the Court has noted that since *Edgar* was not a majority decision its "reasoning" is not binding. CTS Corp. v. Dynamics Corp. of America, 107 S.Ct. 1637, 1645 (1987).

37. *Id.* at 634. The Court specified three ways in which the statute tipped the balance in favor of management of the target company. First, the statute required the bidder to inform the target company of its planned tender offer at least 20 days before the effective date of the tender, and it further required that the offeror refrain from communicating with the shareholders in any way during this period. ILL. REV. STAT. ch. 121 1/2, para. 137.54.E, 137.54.B, 137.54.A (1979) (repealed 1983). The Court held that these provisions frustrate "the objectives of the Williams Act" by providing "incumbent management with a powerful tool to combat tender offers, perhaps to the detriment of the stockholders who will not have an offer before them during this period." *Edgar*, 457 U.S. at 635. Second, the statute gave authority to the Illinois Secretary of State to call a hearing "with respect to any tender offer," and the offer could not proceed until the hearing was completed. ILL. REV. STAT. ch. 121 1/2, para. 137.57.A, 137.57.B. Since the Secretary could delay completion of the hearing indefinitely, the provision provided a way for an official to defeat the offer. The provisions were therefore in conflict with the Williams Act. *Edgar*, 457 U.S. at 636-39. Finally, the Illinois statute provided that the Secretary of State could disapprove of the offer if he adjudged it unfair. ILL. REV. STAT. para. 137.57.E. This conflicted with the intent of Congress, as embodied in the Williams Act, "for investors to be free to make their own decisions." *Edgar*, 457 U.S. at 639.

In addition to the destruction of the balance between bidder and incumbent management, the Court held the statute unconstitutional as "a direct restraint on interstate commerce," having "a sweeping extraterritorial effect." *Id.* at 642.

that case.[38]

After *Edgar*, states began exploring new ways to regulate takeovers, concentrating on the two-tier takeover. The statutes enacted were initially of three main types,[39] with a fourth variation emerging more recently.[40] The most popular approach has been the fair price statute,[41] which generally requires that the offeror pay shareholders in the second step of a takeover the highest price previously paid for any shares.[42] Another kind of statute, often called a control share acquisition statute, gives shareholders the power to decide whether an entity purchasing large numbers of shares may vote them.[43] A third type of statute confers redemption rights on shareholders when an acquirer gets at least thirty percent of a company's shares.[44] A more recent variation is probably destined to become the dominant type, because it has been adopted, in slightly different forms, by Delaware and New York.[45] This approach bans second-tier mergers for a specified number of years after the initial tender offer.

North Carolina's Shareholder Protection Act could fairly be described as a "shotgun" fair price statute, providing not one but three ways of determining the price a bidder must pay shareholders in the second tier of a takeover. In addition, the Act sets requirements for the bidder's conduct after the first tier of purchases but before the second, sets some limitations on the financing of a takeover, and establishes rules for submission of the proposal for merger or other combination to the shareholders.

The Act applies to corporations organized under the laws of North Carolina[46] or foreign corporations having a substantial presence in the state.[47] The

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38. Note, *Securities Regulation: The Validity of North Carolina's Tender Offer Disclosure Act*, 19 WAKE FOREST L. REV. 267, 284, 288 (1983).

39. Pinto, *Takeover Statutes: The Dormant Commerce Clause and State Corporate Law*, 41 U. MIAMI L. REV. 473, 478-83 (1987); Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 115-17 (1987); Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 725 (1987) [hereinafter "State Competition Debate"].

40. Note, *The Constitutionality of Second Generation Takeover Statutes*, 73 VA. L. REV. 203, 211-12 (1987).

41. Romano, *State Competition Debate*, *supra* note 39, at 725.

42. *Id.* See the Illinois and Maryland statutes for examples of highest price provisions. ILL. ANN. STAT. ch. 32 para. 7.85B. (Smith-Hurd Supp. 1986); MD. CORPS & ASS'NS CODE § 3-603(b)(1)(iii) (1985).

43. *Id.* North Carolina passed a control share acquisition statute in 1987. *See* N.C. GEN. STAT. § 55-90 to -98.1 (Cum. Supp. 1987). Under this act, shareholders can deny voting rights to control shares, *id.* § 55-94, and they may redeem their shares at a fair value if one investor purchases a majority of the outstanding shares in the company. *Id.* § 55-95.

44. *Id. See, e.g.*, 15 PA. CONS. STAT. ANN. § 1910 (Purdon Supp. 1986).

45. The Delaware statute imposes a three-year delay on business combinations between corporations and interested shareholders. The moratorium does not apply to friendly takeovers, to interested shareholders owning 85% or more of the corporation's shares, or to combinations approved by two-thirds of the disinterested shareholders (voting by proxy not allowed). Del. Code § 203, *Business Combinations With Interested Shareholders*, 20 Sec. Reg. & L. Rep. (BNA) 209 (Feb. 5, 1988). The New York statute imposes a five-year moratorium on business combinations unless the purchase of a controlling interest was approved at the time of purchase by the corporation's board. N.Y. BUS. CORP. LAW § 912(b) (McKinney 1986).

46. N.C. GEN. STAT. § 55-75(b)(3a)(1) (Cum. Supp. 1987).

47. *Id.* § 55-75(b)(3a)(2). Specifically, the foreign corporation falling within the terms of the Act is one

> (i) which has its principal place of business in this State, (ii) which at the end of each of its

Act includes an exemption, however, for corporations not having "shares of any class, or series, listed on a national securities exchange or held of record by more than 2,000 shareholders at the time such other entity acquired in excess of ten percent (10%) of the voting shares. . . ."[48] The Act also exempts corporations that have opted out of its protections.[49] Corporations in existence at the time the Act was passed must have opted out within ninety days from the effective date of the Act, and corporations may opt out by including a provision to that effect in their articles of incorporation.[50] No provision in the Act forecloses to an existing corporation the option of setting up a new corporation with opt-out provisions, then merging into that corporation before proceeding with the combination.[51] This would, however, be contrary to the spirit of the Act.

The enforcement mechanism in the statute is the "Voting requirement" provision.[52] This section provides that any "business combination"[53] with an entity owning more than twenty percent of the voting shares of the corporation must be approved by ninety-five percent of the voting shares.[54] If a takeover is contested at all, no party could possibly muster ninety-five percent of the votes. Even without a contest the ninety-five percent threshold will be elusive because

> last two fiscal years and at the end of its most recent fiscal quarter has more than forty percent (40%) of domestic fixed assets in this State, (iii) more than ten percent (10%) of the beneficial owners of the voting stock of which are resident in this State; and (iv) of which more than forty percent (40%) of the persons employed by such corporation in the United States are resident in this State.

Id. Although the extraterritorial reach of the Act was part of the originally passed statute, the statute originally covered corporations with 50% of their assets and 50% of their employees in the state. Nine days after the Act was enacted, the General Assembly amended it to lower the required percentages to 40%. An Act to Amend the North Carolina Shareholder Protection Act, ch. 124, 1987 N.C. Sess. Laws 1.

48. N.C. GEN. STAT. § 55-79 (Cum. Supp. 1987).

49. N.C. GEN. STAT. § 55-79 (Cum. Supp. 1987).

50. *Id.* The Act also exempts any agreements for business combinations existing as of April 23, 1987. *Id.*

51. Hazen, *supra* note 11, at n.12.

52. N.C. GEN. STAT. § 55-76 (Cum. Supp. 1987).

53. The Act defines "business combination" to include

> any merger or consolidation of a corporation with or into any other corporation, or the sale or lease of all or any substantial part of the corporation's assets to, or any payment, sale or lease to the corporation or any subsidiary thereof in exchange for securities of the corporation of any assets (except assets having an aggregate fair market value of less than five million dollars ($5,000,000)) of any other entity.

Id. § 55-75 (b)(1).

54. The entity seeking the merger cannot escape the requirements of the Act by reducing its holdings below 20% "if, as of the record date for the determination of shareholders entitled to notice of and to vote on the business combination, the other entity is an 'affiliate' of the corporation." N.C. GEN. STAT. § 55-78(a) (Cum. Supp. 1987). The usage in this provision is confusing, since "corporation" could mean either the target corporation in the takeover or a corporate transferee from the "other entity." The context suggests that the latter interpretation is the correct one, though this is clearly a case of hasty draftsmanship, since the transferee from the other entity will not necessarily be a corporation. Another provision in this section supports the interpretation that the bidder cannot avoid the requirements of the Act by transferring to a third entity with which it is an affiliate. Section 55-78(c)(ii) grants power to the continuing directors of the target corporation to determine whether "an other entity is an 'affiliate' or 'associate' of another . . . ." Id. § 55-78(c)(ii).

Section 55-75(b)(6) says that "affiliate" is used as defined in the 1934 Exchange Act, which defines "affiliate" as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." 17 C.F.R. § 240.12b-2 (1987).

of shareholder inertia and because shares and shareholders may be lost. Thus, the voting requirement effectively forces business combinations to comply with the other provisions of the Act which render the voting requirement inapplicable.

A bidder can escape the voting requirement, first, by complying with the fair price requirements of section 55-77. The statutorily mandated price can be calculated in three ways.[55] The first might be called a highest premium price. The statutory formula compares (1) the highest price previously paid for any shares with (2) the market price at the time of the bidder's first purchase, and requires that the price paid in the second tier reflect a similar premium with respect to the market price "immediately prior to the announcement of such business combination."[56] That is, the proportional premium previously paid must be paid in the second tier, but this time the premium is a proportion of the later market price rather than the price at the time of the first purchase.

The second price calculation is a straight highest price requirement.[57] The price must be "not less than the highest per share price (including brokerage commissions and/or soliciting dealers' fees) paid by such other entity in acquiring any of its holdings of the shares of corporation's [sic] common stock."[58]

The third price calculation is more complex, combining the earnings of the corporation with the price/earnings ratio of the bidder.[59] The statutory formula requires that the price per share be no less than the earnings per share of the target company multiplied by the price/earnings multiple of the bidder. For analysis, the formula can be written:[60]

$$\frac{(EPS)T}{1} \times \frac{SP}{(EPS)B}$$

If the earnings per share of the two companies are the same, the p/e formula will produce a price equal to the acquirer's share price:

$$\frac{\cancel{(EPS)T}}{1} \times \frac{SP}{\cancel{(EPS)B}} = \frac{SP}{1}$$

55. The bidder would have to offer the highest price indicated by any of the three calculations, since that is the only way it could satisfy fully the requirements of § 55-77.

56. N.C. GEN. STAT. § 55-75 (1) (Cum. Supp. 1987). The statute expresses this as a ratio that can be rendered: X/MPA = HP/MP1, where X = required price, MPA = market price at time of announcement, HP = highest price paid, and MP1 = market price at time of first purchase. Solving the equation, the bidder would offer a price of

$$\frac{HP}{MP1} \times MPA$$

57. N.C. GEN. STAT. § 55-75 (2)(i) (Cum. Supp. 1987).

58. *Id.*

59. N.C. GEN. STAT. § 55-75(2)(ii) (Cum. Supp. 1987). The bid price must be

> not less than the earnings per share of the corporation's common stock for the four full consecutive fiscal quarters immediately preceding the record date for the solicitation of votes on such business combination, multiplied by the then price/earnings multiple, if any, of such other entity as customarily computed and reported in the financial community.

Id.

60. (EPS)T = target corporation's earnings per share; SP = bidder's share price; (EPS)B = bidder's earnings per share.

If the target's earnings per share are greater than the acquirer's, the p/e formula will produce a correspondingly higher share price.[61]

Satisfaction of the price requirements, however, will not by itself liberate a bidder from the ninety-five percent voting provision. The Act also places restrictions on the bidder's conduct in the period between the threshold purchase of an interest greater than twenty percent and the time of the second tier merger.[62] The restrictions apply even if the bidder came under the purview of the Act at a time it was not contemplating a takeover. First, the bidder

> shall have taken steps to ensure that the corporation's board of directors included at all times representation by continuing directors proportionate to the outstanding shares of the corporation's common stock held by persons not affiliated with the other entity (with a continuing director to occupy any resulting fractional board position) . . . .[63]

The Act does not, however, indicate what "steps" the bidder must "have taken." Given a weak reading, it could mean that the bidder must not have attempted to control a number of directorships disproportionate to its ownership. A stronger reading could require the bidder to play a more active role in ensuring representation on the board by "continuing directors,"[64] which could include nominating directors or soliciting proxies for continuing directors.[65]

The second conduct restriction prohibits the bidder from acquiring "any newly issued shares of the corporation's capital stock . . . ."[66] This provision could become important if the target corporation issues new shares in order to dilute the proportional ownership of the acquirer.[67] The acquirer would have to match any new issues with purchases of shares already issued just to maintain its proportional ownership.

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61. The price will increase in a direct, rather than a geometric, proportion to the increase in the target's earnings per share over the bidder's.

62. For provisions governing the bidder's conduct, see N.C. GEN. STAT. § 55-77(3) (Cum. Supp. 1987). This section includes one requirement that does not govern bidder's conduct, § 55-77(3)(ii). The requirement is discussed *infra* at notes 62-65 and accompanying text.

63. N.C. GEN. STAT. § 55-75(3)(i) (Cum. Supp. 1987).

64. A "continuing director" is

> a person who was a member of the board of directors of the corporation elected by the public shareholders prior to the time that the other entity acquired in excess of ten percent (10%) of the voting shares of the corporation, or a person recommended to succeed a continuing director by a majority of the continuing directors.

Id. § 55-75(b)(3). It is worth noting that continuing directors do not include directors elected during the period between the bidder's purchase of greater than ten percent of the voting shares and its purchase of the remaining shares that trigger the Act. As a result, any directors elected, for example, under a cumulative voting system by the bidder during the interim period could not qualify as continuing directors, even though they were elected before the Act became applicable.

65. The ambiguities here could be irrelevant in practice, since shareholders could, under the Control Share Acquisition Act, deny the bidder the right to vote its shares in proportion to its actual ownership. If the bidder acquires 20% of the voting shares, he may under certain conditions be unable to vote the shares without shareholder approval. N.C. GEN. STAT. § 55-90(b)(3), 55-94 (Cum. Supp. 1987).

66. *Id.* § 55-77(3)(iii). The bidder may, however, acquire new issues "upon conversion of any convertible securities acquired . . . prior to obtaining a twenty percent (20%) interest or as a result of a pro rata stock dividend or stock split . . . ." *Id.*

67. *See* E. ARANOW & H. EINHORN, *supra* note 1, at 247-49 (dilution as defense to hostile takeover).

However, the final conduct requirement prohibits the acquirer from buying "any additional shares of the corporation's outstanding common stock, or securities convertible into common stock, except as part of the transaction which resulted in the other entity acquiring its twenty percent (20%) interest . . . ."[68] The effect of this provision is that if the target company issues new shares, the bidder may not respond in any way to maintain its proportional ownership and control.

In addition to share price and bidder's conduct, the Act regulates the financing of the takeover, though the terms by which it does so are oblique. If the bidder is to escape the ninety-five percent vote requirement, it may not have "received the benefit, directly or indirectly, except proportionately with other shareholders, of any loans, advances, guarantees, pledges, or other financial assistance or tax credits provided by the corporation . . . ."[69] The bidder might have various reasons to use financial assistance from the corporation, but the most relevant in the takeover context is likely to be assistance in financing the takeover itself.[70] Thus, the provision has the effect of prohibiting leveraged buyouts or any variant in which the corporation guarantees the loans used for the purchase and the corporation's funds are used to repay the loans.[71]

A third set of provisions places restrictions on the acts of the board of directors during the period between the first and second tiers of the takeover. If the bidder is to avoid the ninety-five percent voting requirement, there must not have been any "reduction in the rate of dividends payable on the corporation's common stock, except as may have been approved by a unanimous vote of its directors . . . ."[72] A similar provision prohibits "any major change in the corporation's business or equity capital structure unless by a unanimous vote of the directors . . . ."[73]

Finally, the Act prescribes the procedure for approving the merger or other combination.[74] The target board must mail to the public shareholders a proxy statement, in accordance with the proxy rules of the Securities Exchange Act,[75] to solicit shareholder approval of the combination.[76] The continuing directors must be given access to the proxy statement, and any one of them may express an opinion "as to the advisability or inadvisability of the business combination."[77]

68. N.C. GEN. STAT. § 55-77(3)(iv) (Cum. Supp. 1987).

69. *Id.* § 55-77(4)(i).

70. The Maryland fair price statute is more explicit than the North Carolina Act, prohibiting loans and guarantees "whether in anticipation of or in connection with such business combination or otherwise." MD. CORPS & ASS'NS CODE § 3-603(b)(5) (1985 & Supp. 1986).

71. Bryan, *Leveraged Buyouts and Tax Policy*, 65 N.C.L. REV. 1039, 1040 (1987).

72. N.C. GEN. STAT. § 55-77(3)(ii) (Cum. Supp. 1987). As this provision is worded, there may be some room for incumbent management, if the bidder controls less than a majority of the voting shares, to sabotage a takeover by reducing the dividend rate by a less than unanimous vote.

73. *Id.* § 55-77(4)(ii).

74. *Id.* § 55-77(5).

75. 15 U.S.C.A. § 78n (West 1981).

76. N.C. GEN. STAT. § 55-77(5) (Cum. Supp. 1987).

77. *Id.* If a majority of the continuing directors agree, the proxy statement may include an

The title of the Shareholder Protection Act proclaims its ostensible purpose. Given a takeover attempt, the Act will work to the benefit of shareholders. The price provisions will assure them a share in the control premium. The conduct provisions will prohibit manipulations of the company harmful to the interests of shareholders. At the same time, however, the Act is an antitakeover act, which means that takeovers will occur less often; this will result in fewer shareholder opportunities to benefit from sales of control premiums.[78] In fact, it is not an overstatement to say that the Act is *primarily* an antitakeover statute, and that shareholder protection is subordinate to the antitakeover and management entrenchment function. In addition to the history of the Act,[79] the pricing provisions support this view, because they neutralize two of the leading elements of an attractive two-tier takeover. The Act undermines both the bidder's strategy and the target's characteristics, rendering takeovers either cost-prohibitive or unattractive. The highest premium provision not only prohibits differential treatment of shareholders, regardless of fairness to second-tier shareholders, but it makes the bidder unable to anticipate with any certainty the ultimate cost of the takeover, because the statutory price may be driven up by the market price. The price/earnings pricing formula neutralizes the effect of a target company's low price/earnings ratio, thus making it a less attractive merger candidate. In enacting the statute, the General Assembly has rejected the "neutrality" approach of the Williams Act[80] and adopted, with apparently little deliberation, the theory that two-tier takeovers are harmful and should be regulated out of existence.

Under the North Carolina Act, the highest premium formula[81] may produce a statutory price higher than any previous highest price if the market value at the time of the announcement of the combination has risen from the market value at the time of the bidder's first purchase of the corporation's shares.[82] Because the formula relies on a fluctuating market price, a bidder will be handicapped in trying to determine how much to offer per share in the original tender offer. The initial offer must be set in light of the total contemplated acquisition price. But because the bidder cannot anticipate with any certainty the market

opinion from "a reputable investment banking firm as to the fairness (or not) of the terms of the business combination to the remaining public shareholders. . . ." *Id.*

78. Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 698 (1982) ("Any attempt to require sharing simply reduces the likelihood that there will be gains to share.").

79. *See supra* notes 9-11 and accompanying text.

80. *See supra* note 25 and accompanying text.

81. *See supra* notes 55-56 and accompanying text.

82. Since the price is

$$\frac{HP}{MP1} \times MPA$$

(*see supra* note 56) any excess of HP over MP1 will produce a quotient greater than one, which, multiplied by the current market price, will produce a statutory price greater than the current market price. If the current market price is greater than MP1, the statutory price will be greater than any previous highest price.

One effect of the highest premium formula will be that shareholders who did not tender or who were "pro-rated out" in the first tier may benefit if the tender offer has increased the market price. Finkelstein, *supra* note 2, at 296.

price after his initial offer, the price in the initial offer becomes a gamble in which the stakes are too large. The highest premium price may not be a factor in a takeover under the Act if the share price has fallen sufficiently since the bidder's first purchase. However, the more likely fact situation is that the share price will have risen since the first purchase, especially when the Act guarantees a premium to shareholders that rises proportionally to any increase in the market price.[83]

The Act further destabilizes the bidder's position because it does not place any time limitations on the share purchases to be used in the highest premium calculation. As a result the benchmark market price could be a price from many years before when the bidder made a purchase of shares without any intention of initiating a takeover. By contrast, both the Maryland and Illinois takeover statutes, similar in many respects to North Carolina's, set a two-year window for locating the highest price previously paid and the market price at the time of the first purchase.[84] The two-year restriction makes the highest premium calculation more rational, because its results should for the most part reflect premiums paid as part of the takeover scheme. North Carolina's approach could defeat the intent to require payment of a highest premium by introducing figures peripheral to the takeover.

On the one hand, the highest premium formula destabilizes the bidder's position. On the other, the price/earnings formula completes the antitakeover scheme by undermining the target's attractiveness as a merger candidate.[85] The p/e formula is ostensibly a shareholder protection provision, and an analysis of the formula will profit from an understanding of its significance for shareholders. The provision embodies a novel and intriguing concept, seeking to reflect the value of the company rather than the vagaries of the market, and the share price the formula generates should give the public shareholder an amount corresponding to the earning power of the company. This approach has an advantage over formulas based on market price because the company's earnings are not as liable to distortion resulting from the takeover bid as is the market price of the shares.[86] In the p/e formula, the bidder's share price is important, but that figure is not likely to be as volatile as the target's share price, which does not figure at all in the formula.

To see how the p/e formula affects both purchasers and target shareholders, consider our fictional Predator's attempted takeover of Lamb Industries.[87] Suppose Predator has a price/earnings multiple of twenty, while Lamb's is a more conservative ten. According to Aranow and Einhorn, the leading charac-

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83. Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345, 360-65 (1980) (empirical study showing increase in value of shares following announcement of successful tender offer).

84. ILL. ANN. STAT. ch. 32, para. 7.85B. (Smith-Hurd Supp. 1986); MD. CORPS & ASS'NS CODE § 3-603(b)(1)(iii) (1985).

85. *See supra* notes 59-61 and accompanying text.

86. On the other hand, the target company's earnings may be distorted if the company has taken costly defensive measures in response to the takeover attempt.

87. *See supra* notes 1-2 and accompanying text.

teristic of an attractive takeover target is that its p/e ratio is lower than the bidder's, especially if the bidder's is inflated. By merging with a company carrying a lower p/e ratio, Predator can lower its p/e ratio without actually increasing its earnings.[88]

In order to isolate the effect of differing p/e ratios under the formula, assume that the shares of Predator and Lamb are selling at the same price, $20. Lamb's earnings are then $2 per share. The statutory formula requires that Predator's price/earnings ratio, 20/1, be multiplied by $2. The price Predator will have to pay for each share of Lamb is thus $40, double the market price. The rationale of the formula becomes clear if it is applied to a share exchange. In a share exchange, Lamb shareholders will receive two shares of Predator for one share of Lamb. At Predator's 20 to 1 p/e ratio, they will need the two shares of Predator to earn the amount one share of Lamb produced at 10 to 1. The rationale of the provision is less clear, however, in light of the fact that shareholders may receive a significant windfall if they sell their shares immediately, or if the formula is used to determine a cash price rather than a share exchange. The potential extremity of the result intimates that the formula may have another function.

The "other function" of the p/e formula, the one showing it to be primarily an antitakeover provision, is to neutralize the business purpose for a bidder's pursuing a company with a lower p/e ratio. Because the bidder will have to pay a premium for the higher earning power per share of the target, the bidder's earnings will be depleted by the purchase to the same degree the purchase would otherwise boost its earnings power.

A hypothetical will demonstrate how the p/e formula nullifies the effect of a merger on the bidder's price/earnings ratio, assuming the p/e ratio of the target is lower than the bidder's. Assume the following facts:

	Bidder	Target
Share price	$10	$10
P/e ratio	20	10
Earnings per share (EPS)	$.50	$1
Outstanding shares (OS)	10,000	1,000
Earnings (EPS × OS)	$5,000	$1,000

The Act's p/e formula would require issuance of 2,000 shares to the target's shareholders in a share exchange (the equivalent of $2 per share, or 1 × 1/.50), so the bidder would have 12,000 shares outstanding after the merger. Assuming the two companies perform after the merger just as they did in the preceding year, the bidder's earnings would be $6,000 ($5,000 + $1,000). The earnings per share would thus remain at $.50, unchanged from the level before the merger. The advantage to the bidder of the target's low p/e ratio has been offset to the penny.

88. E. ARANOW & H. EINHORN, *supra* note 1, at 2-3.

The debate over the proper aims and methods of takeover regulation is remarkably rich and voluminous. Commentators dispute not only *how* to regulate,[89] but more importantly the prior question of *whether* to regulate.[90] The debate demonstrates that the problem of takeover regulation requires a reevaluation of the Williams Act, with its neutrality approach,[91] and a reexamination of the implications of shareholding as the means of ownership of the corporation.[92]

The approaches to regulation are so many and so various that this Note cannot pretend to carve out the position North Carolina should adopt. Virtually any position the state adopts, whether it encourages takeovers or forestalls them, will be subject to searching and arguably "correct" criticism. The difficult issues involved will only be resolved by a historical development of takeover regulation that seriously addresses the pertinent issues. Consensus will not emerge from the lucubrations of academic commentators. It will only come from legislative action and the consequent results in the marketplace. But legislative action must be deliberate, consulting a broad range of the affected constituency, and it must proceed with a coherent sense of the proper aims of regulation.

North Carolina has not been alone in enacting a takeover statute without hearings and over the objections of the state corporation law bar.[93] But good company in this case should provide no comfort. The General Assembly must squarely face the fact that the Shareholder Protection Act is a strong antitakeover statute, artfully contrived to undermine bidders' strategies and to render targets less attractive. This approach to regulation may be the best for all concerned. Or it may not. The state's legislators need to decide this issue in a deliberate and rational manner.

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89. *See, e.g.*, Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985) (proposal to allow shareholders to tender shares provisionally and to vote on acceptance of the offer); Brudney & Chirelstein, *supra* note 2 (disclosure plus fair price requirements); Goldberg, *Regulation of Hostile Tender Offers: A Dissenting View and Recommended Reforms*, 43 MD. L. REV. 225 (1984) (prohibit a range a defensive tactics, prohibit two-tier offers, impose 120-day waiting period for tender offers to encourage competing offers); Lowenstein, *supra* note 27 (require hostile tender offers to remain open for six months).

90. *See, e.g.*, Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?*, 19 GA. L. REV. 281 (1985) (cost-benefit analysis demonstrates two-tier offers are beneficial and should not be regulated); Easterbrook & Fischel, *supra* note 78, at 698 (regulation not in shareholder interest since it decreases likelihood that there will be gains for shareholders to share); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (managerial defenses to tender offers should be proscribed, and decision should be left entirely to shareholders); Liman, *Has the Tender Offer Movement Gone Too Far?*, 23 N.Y.L. SCH. L. REV. 687, 707 (1978) ("It is fair, therefore, to rise above the tactics of the [tender offer] movement, and ask whether the public interest is being served."); Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231 (1980) (application of business judgment rule to target's consideration of tender offer).

91. Liman, *supra* note 90, at 707; Lowenstein, *supra* note 27, at 252.

92. Lowenstein, *supra* note 27, at 259-62.

93. *See* Romano, *State Competition Debate*, *supra* note 39, at 727 n.51 (Connecticut); Steinberg, *The Pennsylvania Anti-Takeover Legislation*, 12 SEC. REG. L.J. 184, 185 (1984) (Pennsylvania).