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Liberalizing Michigan's Corporate Law

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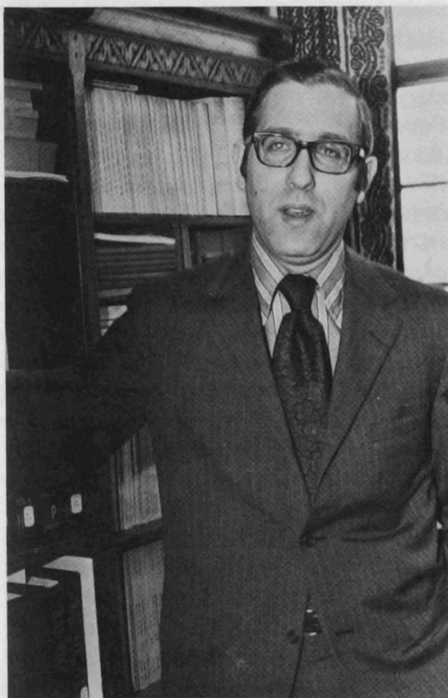
liberalizing MICHIGAN'S CORPORATION LAW

By Professor Stanley Siegel



Professor Stanley Siegel

Prof. Siegel served as Reporter to the Michigan Law Revision Commission to draft the proposed Michigan Business Corporation Law. His remarks reflect his own views, and not necessarily those of the Law Revision Commission.

In the argot of the corporate lawyer, the term "liberal" takes on a special meaning when used to describe a body of laws governing corporations. A "liberal" corporation code contains the minimum number of limitations on corporate activity and has few, if any, sanctions to support its prohibitions. In the early days of this century, New Jersey, and later Delaware, earned the title "Mother of Corporations" by easing the strictures on corporations established under their laws. The fact that corporations even then operated beyond the boundaries of their chartering jurisdictions led to an influx of corporations that leaves its clear mark on American corporation law to this day. Of Fortune's Top 500 Industrial Corporations, more than 200 are incorporated in Delaware, some 60 in New York, and more than 40 in New Jersey.

As the century has progressed, so have the corporation laws. The last two decades have seen "liberalized" revisions of the corporation statutes of nearly every state in the union. The flagship states—New York, New Jersey, and particularly Delaware—have gone far toward eliminating all regulation of corporate activity by state statute. This process of state "liberalization" has not been without its costs. Emerging as the most powerful countervailing force is the Securities Exchange Commission which, through enforcement of the 1933 Securities Act and the 1934 Securities Exchange Act, has expanded significantly the corpus of "federal common law of corporations."

Though it is not perfectly clear that

the liberalization of state corporation law has led to expanded federal limitations on corporations, it has surely contributed to that expansion. Whatever the cause, however, the corporate lawyer today is more likely to be concerned about federal limitations on his client than he is about strictures of the state corporation law—unless his client is a Michigan corporation.

The Michigan General Corporation Act was passed in 1931, and it was a liberal act by the standards of the day. In 1971 it stands as a heavily amended, confusing, and largely archaic statute. An attorney faced with its limitations is well advised to reincorporate his client in Delaware. Indeed, a number of Michigan corporations of long standing have done just that in the last few years.

Early in 1968, the corporation committees of the Michigan senate and house requested that the Michigan Law Revision Commission undertake a revision of the Michigan law of business corporations. The 1970 Annual Report of the Law Revision Commission includes a completely new Michigan Business Corporation Act, which has been introduced into the 1971 legislative session. As proposed, the act would be among the most liberal in the nation; incorporation in Delaware would offer a prospective enterprise little advantage over incorporation in Michigan. The proposal also provides a number of features not now found in the corporation laws of the major states. A summary of the proposed act follows.

For the large corporation with multistate operations, the existence of a sophisticated, current, and liberal corporation statute in any state—Delaware and New Jersey being the current favorites—is sufficient. Such a corporation suffers no disadvantages from simply incorporating in the favored jurisdiction. The small intrastate corporation is a different story; for such an enterprise, incorporation outside of the state of operations entails some costs and complexity. For example, a corporation incorporated outside of the state in which it does business cannot possibly seek the intrastate exemption from the registration requirements of the 1933 Securities Act.

Perhaps the most important changes wrought by the proposed act relate to the closely-held corporation. Throughout the act, provisions are made for solving the unique problems of the "incorporated partnership." In particular, the act validates agreements on voting and control, share transfer restrictions, deadlock-breaking devices, and simplified corporate procedures, all by agreement among the shareholders. In addition, the act provides for the resolution of corporate disputes and deadlocks—which arise particularly in closely-held corporations—in the event the shareholders have established no mechanism of their own for resolution.

Other changes in the act will benefit all corporations. The proposal includes the most streamlined and simplified procedures in the Nation for filing and documentation. All filings are pursuant to a single section, and are made in one copy with one signature. Corporate records may be kept in computer-compatible form, provided arrangements are made for read-outs upon request.

One area of corporate record-keeping and documentation that has emerged as a major problem recently is the universal requirement that shares of stock be evidenced by share certificates. Accounting for, transferring, and safe-keeping of these certificates has become a monumental job as trading volume on and off the exchanges has mushroomed. A number of commentators have suggested that alternatives to share certificates be authorized, but no concrete proposals have yet been approved by the exchanges. The proposed act, noting this development, becomes the first in the nation specifically to authorize elimination of share certificates and establishment of other methods of recording ownership as may be provided by the rules of any national securities exchange.

Many corporation statutes, of which Michigan's existing law is not the most restrictive, exercise their most significant limitations in the area of capital structure and corporate distributions. In most states, par value as a limitation on stock sales price has become less important with the wide use of low-par and no-par stock. Nevertheless, limitations on the use of "stated capital" remain in the form of the requirement that dividends be paid only out of earned surplus. Capital surplus is similarly available for dividends, but usually upon an additional vote of the shareholders. Stated capital—the accumulate par or stated value of outstanding shares—must remain intact. This structure is a legacy from the days when businessmen and scholars alike viewed the paid in capital of a corporation as security for the payment of its creditors. Few serious students of finance would argue today that creditors rely upon the stated capital of a corporation. Their security lies in the corporation's earnings, which provide the corporation with the ability to pay debt service. Statutes that attempt (as many now do) to maintain a core of assets for payment of creditors are mistaken in their fundamental assumptions.

Moreover, statutes that have limited the ability of corporations to pay dividends and make other distributions have gradually been eroded to the point where the well-advised corporation may generally (through a series of steps) declare any dividends up to the point where the distributions threaten corporate insolvency. The proposed Michigan Act recognizes this fact forthrightly: dividends may be paid out of any surplus unless insolvency is threatened. Moreover, increases in the value of the corporation's assets, even if not realized by sale of the assets (so-called "unrealized appreciation") may be utilized in calculating the corporation's dividend-paying ability. Finally, the stated capital of a corporation may be reduced pursuant to greatly simplified procedures. All of these procedures, however, including the sources from which dividends are to be paid, become the subject of complete disclosure to the shareholders. By recognizing the financial facts of life, the proposed act does not in any substantial way water down the protection of creditors. Rather, it destroys the premium on complex and unnecessary legal maneuvering in the capital structure area.

Much interest has recently been focused on problems, both personal and institutional, concerning the board of directors. On the one hand, greater leeway must be provided to allow directors to act other than in the setting of a formal meeting. On the other, directors have (not without cause) become fearful

One of the principal roadblocks to the effectuation of a merger is the appraisal remedy, a formerly universal provision under which dissenters to a major corporate change may demand payment from the corporation equal to the fair value of their shares. . . . Corporations unhappy with traditional appraisal statutes will simply reincorporate in Delaware. The appraisal remedy may simply be one of the inevitable casualties of the federal system.

that however they act they will be subject to potentially crushing personal liability. The proposed act addresses the first of these problems by allowing action of the board without a meeting upon unanimous consent, by broadly allowing delegations of authority by the board of directors, and by permitting attendance at a meeting of the board through conference telephone or similar facilities. In addition, the proposal deals with the problem of transactions by "interested" members of the board of directors (*e.g.,* dealings with other corporations in which they have a managerial or financial interest), allowing their validation through any of several alternative procedures: determination of fairness, disinterested vote of directors, or disinterested vote of shareholders.

The problem of director liability—posed in striking terms in the *Bar Chris* case—had already been the subject of extensive discussion at the time the revision effort was initiated. Delaware and the Model Act, in a joint drafting effort, adopted extensively "liberalized" indemnification procedures. The Michigan proposal advances some of the features of the Delaware-Model Act section. It distinguishes indemnification as to third-party actions (allowing indemnification for judgments as well as expenses) from indemnification as to actions by the shareholders and the corporation itself (allowing indemnification for expenses only). Indemnification is mandatory in either situation where the defendant is successful on the merits or otherwise. Two aspects of the Delaware-Model Act formulation were rejected. Literally read, that language would permit indemnification of a director who made profits on transactions in his company's own shares based on inside information about the company, the *Texas Gulf Sulphur* situation. Moreover, the "nonexclusive clause" of that statutory language would, literally, allow a corporation to indemnify by contract without any limitations, despite the limitations expressed elsewhere in the statutory language. Both the Securities Exchange Commission and the chairman of the House Banking Committee (Rep. Wright Patman) have expressed doubts as to the validity of these aspects of the statute. Indeed, quite apart from questions of legal validity, it seems hardly likely that a corporation could justify indemnifying its directors beyond the limits expressed in the statute or in the *Texas Gulf Sulphur* situation.

The proposed Michigan indemnification section requires as a condition of indemnification that the director or officer indemnified "acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation *or its shareholders. . . .*" The italicized language would preclude indemnification in the *Texas Gulf Sulphur* situation. The Michigan language also limits the "nonexclusive clause" by providing that indemnification outside of the specific statutory terms "shall be invalid only insofar as it is in conflict with this section." Despite this narrowing of the Delaware-Model Act language, Michigan corporations will be capable of indemnifying directors and officers against any legitimate and reasonable risk of office short of intentional violation of the law.

For many years, Delaware has been a favored incorporation jurisdiction of expanding corporations largely because of the ease with which Delaware corporations can effect mergers and other business combinations. Delaware's recent corporation law revision substantially eased the already simple procedures. The proposed Michigan act would make merger in this state in virtually every respect as easy and inexpensive as in Delaware; and, indeed, simpler in at least one respect (appraisal remedy, discussed below).

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The proposed statute adopts majority vote throughout for all major corporate actions from merger through amendment of the articles of incorporation. The now common "short merger" section (allowing merger without any vote if one corporation owns 90% of the outstanding shares of each class of another corporation) is included in the revision in its most liberal form. In addition, the revision includes Delaware's provision allowing a merger without a vote of the surviving corporation where common stock issued under the plan does not exceed 20% of the common stock outstanding immediately prior to the merger. The effect of this section is to allow large conglomerate corporations to expand by merger without a vote of their own shareholders in many situations.

Also adopted from the Delaware statute is a section allowing action by the shareholders without a meeting on any question—including a proposed merger—provided sufficient votes in favor of the action are obtained in writing. Therefore, even in the situation where a shareholder vote will be required for a merger, the statute provides a simplified procedure for taking that vote.

Apart from the cash drain that payment of substantial appraisal demands may occasion, litigation on the question of fair value is frequently extended and costly. Obviously, the appraisal remedy if demanded by any substantial number of shareholders can thwart a merger plan. Equally obviously, at least in the minds of some, if the shares have a ready and fair market, the same protection for the dissenting shareholder can be afforded by his sale of the shares on the market.

Following this reasoning, several states (now followed by the Model Act) have eliminated the appraisal remedy whenever the affected shares have a market. Market is variously defined, but generally involves one or another or both of two criteria: shares held of record by 2,000 or more shareholders, or traded on a national securities exchange. Michigan's proposal goes a step further by eliminating appraisal also whenever the consideration to be given in *exchange* for the affected shares consists of cash or securities with a market. Only in the situation where the shares of the affected corporation have no market *and* the consideration for those shares includes securities with no market will appraisal be preserved.

The reporter dissented to several of these "liberalizing" provisions on the ground that significant protections were lost through their adoption. For example, in the appraised situation, the existence of a market is no guarantee that the market will not decline significantly upon announcement of the merger plan. All appraisal statutes provide for this eventuality by setting fair value independently of the effect of the announcement of the merger. The only remedy to the affected shareholders whose shares decline upon announcement of the merger will now be to seek injunctive relief. These dissents, however, are difficult to maintain in light of the demonstrable fact that if enacted as proposed, the Michigan Business Corporation Act will be among the most liberal in the country. It will eliminate archaic restrictions on corporate activities and will eliminate some valuable shareholder protections as well. On balance, however, it will retain the core of limitations necessary to protect legitimate state interests.