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Michigan Corporations Left Unprotected? The Repeal of the Michigan Control Share Act

by J.J. Burchman

Effective January of 2009, the Michigan Legislature voted to repeal the Michigan Control Share Act ("Act"). The Act applied to the acquisition of certain voting shares in Michigan corporations and was intended to protect the Michigan corporation from a hostile takeover. In effect, the Act stripped the acquiring shares of their voting rights unless the remaining shareholders voted to allow the acquiring shares to continue their voting rights. The Act was one of a number of pieces of legislation enacted by states in the 1980's in an attempt to limit the number of hostile takeovers that were sweeping the country at that time. The Act was primarily aimed at publicly traded Michigan corporations but it also applied to privately held corporations with greater than 100 shareholders of record. In repealing the Act, the legislature reportedly felt that it was not effective in protecting the interests of Michigan corporations facing a hostile takeover. The result, however, potentially leaves Michigan corporations that were relying on the protections of the Act without any protection from hostile takeover bids. With the repeal of the Act, Michigan corporations should investigate alternative means for protecting their company.

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With the repeal of the Act, there remain several individual solutions that may prove to be beneficial for a corporation to resist hostile takeovers. These solutions fall into five main categories: (1) supermajority provisions; (2) classified or staggered board provisions; (3) fair-price provisions; (4) reduction or elimination of cumulative voting; and (5) poison pill provisions. This article will summarize the five categories and outline possible solutions for your corporation.

Methods

Supermajority Provisions

Under Michigan corporate law, a majority of shareholder votes is generally required for most actions, including mergers. With a supermajority provision, a corporation may increase the shareholder approval requirement for a merger above that 50% threshold. Commonly, a corporation would opt to increase the required approval to anywhere from 66% to 80%. In conjunction with increasing the percentage, it is generally recommended that the amendment grant the board of directors the power to waive the increased percentage requirement. By increasing the required shareholder percentage, a corporation may be able to block an acquirer from implementing a merger even when the acquirer controls the target's board of directors if the acquirer's share ownership remains below the increased threshold. The practical effect on a potential acquisition of increasing the required approval percentage is to encourage any potential acquirer to deal directly with the target's board of directors, as

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the board has the ability to waive the increased percentage provision. Increasing the percentage without a board waiver provision is not generally recommended as it would seriously limit management's flexibility in any potential takeover negotiations.

Classified or Staggered Board Provisions

Typically, the shareholders elect the entire board of directors to one-year terms at each annual meeting. To better protect the company, it may be advisable to provide for three classes of directors with each director serving a staggered three year term (i.e., a third of the board is elected each year for a three year term). By staggering the terms of the board of directors, any potential acquirer is forced to wait for two annual meetings before being guaranteed control of the board of directors and, therefore, a successful proposal for merger. Along with the change to three classes, an amendment generally contains a provision indicating that a supermajority of shareholders must approve any increase in the size of the board of directors. By doing so, the corporation prevents the potential acquirer from expanding the board of directors and circumventing the purpose of having three classes of directors. In addition, there may be additional advantages to moving to classes of directors in that it provides the benefits of continuity and stability to the board of directors at large.

Fair-Price Provisions

A fair-price provision restricts the transfer of control of a corporation if the acquirer does not offer a "fair" price. A "fair" price is usually defined as the highest price paid by the acquirer for any shares acquired in the target corporation during a specified time period or it may be defined as some premium over the market price. A supermajority of shareholders must approve the transaction if the acquirer does not meet the fair price. This type of provision is usually most effective against a two-tiered acquisition where the acquirer offers an attractive price for a fixed percentage of shares with the intention of paying a lower price to the remaining, minority shareholders if the initial bid is successful. While the provision does not attempt to prevent a takeover as some of the other discussed provisions do, this type of provision ensures that existing shareholders get equal compensation for their shares. An acquirer would simply make a uniform offer to all shareholders to avoid complications under a fair price provision.

Reduction or Elimination of Cumulative Voting

Under Michigan law, the default for corporations is that votes may not be cumulated. It requires a provision in the articles of incorporation of a corporation to permit its shareholders to cumulate their votes. Consequently, it may not even be an issue for your company. Cumulative voting means a shareholder is entitled to votes in the amount of the number of shares owned multiplied by the number of directors standing for election. Effectively, it allows a minority shareholder to cumulate its votes and potentially elect a director who the majority shareholders oppose. For those corporations that currently have cumulative voting, it may make sense to either restrict cumulative voting to non-merger issues or eliminate cumulative voting altogether.

Poison Pills

There are a number of different strategies to poison pills, but the basic idea is to make the acquisition substantially more expensive for the acquirer. Generally, a poison pill is triggered when an acquirer purchases a set percentage of the shares of the corporation. Poison pills usually are in place for a finite period of time (commonly 10 years). There are three main types of poison pills: (1) flip-in, (2) flip-over, and (3) back-end plan. The flip-in plan involves management or the board of directors offering all shareholders other than the acquirer the opportunity to purchase additional stock in the company at a steep discount. By doing so, the acquirer has to purchase many more shares as the company's stock has become diluted by the offer. A flip-over plan occurs at the end of a hostile takeover.

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The existing shareholders are granted the option to purchase the acquirer's shares at a discount, thereby devaluing the acquirer's stock and diluting its stake in the company. Finally, the back-end plan grants existing shareholders the right to sell shares to the acquirer at a premium after the hostile takeover concludes. A poison pill is implemented by the board of directors and management and does not need shareholder approval to take effect. Given that, there are some corporate governance and shareholder relation issues to consider when considering implementing this procedure.

Implementation

Of the potential anti-takeover provisions discussed, all but the poison pill method require an amendment to the corporation's articles of incorporation which, in turn, requires shareholder approval. A concurrent amendment of the bylaws is required to eliminate any conflicts between the bylaws and the articles of incorporation. The poison pill, however, does not require shareholder approval and may be implemented by management or the board of directors. Consequently, poison pills are much more controversial than the other methods, especially in the recent environment of increased emphasis on shareholder rights and shareholder activism.

Conclusion

With the repeal of the Act, Michigan corporations who previously may have been relying on the Act for protection against hostile takeovers need to re-examine their position. Without the Act's protections, a Michigan corporation is more vulnerable to a hostile takeover and may need to consider implementing provisions to protect itself. The various provisions discussed in this article outline some of the features a corporation may choose to adopt to better protect itself and its shareholders. If your corporation wants to be better protected, please contact us so we can discuss which of these provisions may be best suited to protect your corporation and its shareholders.

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