CORPORATE

SECTION 488, REVISITED: OPPORTUNITIES FOR FLEXIBLE GOVERNANCE FOR MICHIGAN CORPORATIONS

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Introduction

In 1997, the Michigan Legislature added Section 488[1] to the Michigan Business Corporation Act ("MBCA").[2] The act was greeted with fanfare by the State Bar of Michigan and the business community, which had sought to "address the special needs of small corporations whose operations did not neatly fit" the MBCA as then enacted.[3]

Based on Section 7.32 of the Model Business Corporation Act (the "Model Act"),[4] Section 488 allows a corporation's shareholders to alter the entity's governance by adopting a shareholder agreement (a "Section 488 Agreement"). The Section 488 Agreement can include such provisions as eliminating the board of directors, establishing the manner of electing or removing directors and officers, and the like. As a result, Section 488 "authorizes a high but not unlimited degree of flexibility"[5] for corporations to determine their own elements of governance.

However, by the time Section 488 was adopted, the Limited Liability Company Act,[6] enacted by the Michigan Legislature in 1993, had already begun to gain favor among those forming entities in the state of Michigan. In fact, between October 1, 1997, and September 30, 1998, over 16,000 Michigan LLCs were organized, as compared to almost 26,000 corporations.[7] In subsequent years, the shift towards LLCs in Michigan (and elsewhere) has become more pronounced; from October 1, 1998 through September 1, 2010, 464,017 LLCs were organized in Michigan; in that same time period, only 224,876 corporations were incorporated.[8] As a consequence, many of the types of enterprises that would most benefit from the flexibility of Section 488 have opted to form LLCs instead.

It appears that Section 488 has not had as dramatic an impact as was envisioned at its enactment. In spite of the recent migration to LLCs, however, corporations continue to be formed, and existing corporations continue to operate. For these entities, Section 488 "gives shareholders in smaller corporations a great deal of flexibility in tailoring the structures and operations of their corporations to fit their needs."[9] So, as the 15-year anniversary of the enactment of Section 488 approaches, perhaps now is a good time to revisit an underused and often overlooked provision.

This article will attempt to "reintroduce" Section 488 by providing an overview of the statute, as well as discussing possible practical applications, and highlighting a few issues to address when drafting a Section 488 Agreement.

Overview of Section 488

Section 488 expressly authorizes the shareholders of non-publicly traded corporations to enter into various types of agreements, even when those agreements are inconsistent with other MBCA provisions.

Section 488 grants substantial power to a corporation's shareholders to determine how the corporation will be managed and to structure the relationship among the shareholders, directors, and the corporation.

Section 488(1)(a)-(g) specifically allows Section 488 Agreements to address the following provisions:

- Restricting the power of the board of directors or eliminating the board of directors entirely.[10]
- Allowing unequal distributions to shareholders.[11]
- Electing directors and officers and the manner of removing directors
- and officers.[12]
- Permitting weighted voting power among shareholders and directors,
- and director proxies.[13]
- Establishing terms and conditions of interested shareholder, director, officer, and employee transactions.[14]
- Delegating to shareholders, or other persons, management powers normally reserved for the board of directors, including the right to break deadlocks among directors or shareholders.[15]
- Dissolving the corporation on the request of one or more of the shareholders or the occurrence of a specified event.[16]

Section 488(1)(h) also contains a "catchall" provision that adds further flexibility by validating any other provisions not specifically enumerated in the statute, as long as the provisions are not "contrary to public policy."[17]

Section 488 Agreements must be set forth in the corporation's articles, bylaws,[18] or in a separate written agreement. No matter where the agreement is placed, it must be approved by all persons who are shareholders of the corporation at the time of adoption.[19] Any amendments to the Section 488 Agreement must also be approved by all persons who are shareholders of the corporation at the time of the amendment, unless the original agreement provides otherwise.[20]

The existence of a Section 488 Agreement must be conspicuously noted on all stock certificates issued by the corporation.[21] If the corporation had already issued stock certificates at the time the Section 488 Agreement was adopted, the corporation must recall the certificates and issue substitute certificates that note the existence of the agreement.[22] Although the failure to provide notice of the

existence of the Section 488 Agreement does not affect the validity of the actual agreement, any persons who later become shareholders of the corporation without knowledge of the agreement[23] are entitled to rescind their purchase.[24]

Although shareholders of a corporation are not usually protected by MBCA indemnification and limited liability provisions, shareholders who are vested with the discretion or powers of the board of directors under a Section 488 Agreement are treated as directors under the agreement for purposes of liability for acts or omissions imposed by law on directors, as well as for purposes of indemnification and limitation of such liability.[25]

No matter how much a Section 488 Agreement may alter the typical corporate structure, Section 488 makes it clear that the existence of such an agreement is not grounds for treating the corporation as a partnership or unincorporated entity for purposes of imposing personal liability on the shareholders.[26]

Practical Applications of Section 488

The provisions contained in Section 488(1)(a)-(g) as outlined above provide clear direction on a number of applications of Section 488 Agreements. The statute is quite expansive, however, and is generally limited only by the creativity of counsel and the constraints of public policy. Following are a few examples of how Section 488 Agreements may be used.

Whatever You Need—Within Limits

Counsel should not feel limited by the enumerated list of provisions that are specifically permitted by Section 488(1)(a)-(g). As noted in the commentary to Model Act §7.32, "[t]he enumeration of these types of agreements is not exclusive; nor should it give rise to a negative inference that an agreement of a type that is or might be embraced by one of the categories of section 7.32(a) is, ipso facto, a type of agreement that is not valid unless it complies with section 7.32."[27] Additionally, the "catch all" provision of Section 488(1) (h) provides great flexibility, limited only by the bounds of the drafter's imagination and public policy. However, the commentary to Section 7.32 of the Model Act notes that the "catch all" provision "is intended to be read in context with the preceding seven subsections and to be subject to a ejusdem generis [of the same kind] rule of construction;" as such, in addition to the public policy constraint stated in the statute, "in defining the outer limits, courts should consider whether the variation from the Model Act under consideration is similar to the variations permitted by the first seven subsections."[28]

Replicating LLC Governance

If parties are considering setting up an LLC or converting an existing corporation into an LLC strictly to take advantage of the flexible governance opportunities, a Section 488 Agreement might well eliminate the need to use the LLC form. At least one commentator has observed that the flexibility provided by the "catch all" provision allows a corporation to adopt many, if not all, of the governance mechanisms of a partnership or limited liability company:

> This catch-all is a very useful provision when comparing the utility of a Section 488 agreement with a partnership agreement or limited liability company operating agreement. If a particular contractual provision would be permitted under Michigan law in a partnership agreement or an operating agreement, it would be difficult to argue that such a provision would be against public policy if placed in a Section 488 agreement. Thus, a Section 488 agreement may provide more flexibility [than] a limited liability company or partnership, leaving tax issues aside.[29]

Closely Held Corporations

A closely held corporation, where the shareholder or shareholders serve as the directors and officers and are the primary operators of the enterprise, might benefit from implementing relaxed governance requirements via a Section 488 Agreement—particularly if the corporation has historically been lax about adhering to the typical governance requirements of the MBCA. Section 488 explicitly shields the shareholders from certain liabilities in the event that "the agreement or its performance results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement."[30] This could be very useful in a corporation held by family members, where they might want to allocate most of the operating responsibility in the hands of one family member.

Strong Minority Shareholder Protections

A Section 488 Agreement can contain a number of provisions that provide protections and benefits to minority shareholders:

- The shareholders can establish the composition and number of the board of directors, which remains in place absent amendment to the Section 488 Agreement.[31] This can preserve a board composition that
- is favorable to a minority shareholder, even when the stock ownership
- would otherwise allow majority shareholders to elect a different board of directors. Even if an agreement calls for an equal number of directors selected by a majority and a minority shareholder, the use of weighted voting can allow the minority shareholder to have the ultimate say on at least certain matters put to a board vote.[32]
- The Section 488 Agreement can allocate certain decisions to a subset of directors—who can be either permanently appointed by the minority
- shareholder, or elected solely by the minority shareholder.[33] Eliminating the board and allocating specific authority directly to one or more shareholders can also be done.
- The Section 488 Agreement can allocate selection or removal of the officers to the minority shareholder.[34] In addition, the agreement can govern the terms of services provided by the officers and employees of the corporation, allowing a minority shareholder to regulate and restrict salaries and benefits paid to such individuals.[35]

- Dividend restrictions can be implemented, such that no dividends are paid to the majority shareholders until dividends exceeding a certain threshold are paid to the minority shareholder.[36]
- The agreement can permit one shareholder, acting alone, to exercise the "nuclear option" of dissolving the corporation, should he or she wish to terminate the business relationship for whatever reason. The existence of such an option might provide a minority shareholder with sufficient leverage to impact management and governance issues beyond those that he or she directly controls, through other Section 488 Agreement mechanisms or otherwise.[37]
- It can also require the board to act only in actual meetings (as opposed to consent resolutions), to ensure that there are sufficient opportunities for discussion among the directors. These types of provisions provide minority shareholders with opportunities to give input and guidance, as well as limit the ability of the majority to act precipitously and behind the backs of the minority.

While some of these actions can be accomplished in ways other than a Section 488 Agreement (by amending the corporation's articles or through a voting agreement under Counsel will need to give some thought as to whether a Section 488 Agreement should be included in the bylaws, articles, or separate agreement; each option has advantages and disadvantages. Sectio n 488 re visite d 13 MBCA Section 461, for example), Section 488 is a broad and powerful alternative.

Once a minority shareholder has obtained these types of benefits, it is difficult for the majority shareholders to wrest them away. Absent language in the Section 488 Agreement to the contrary, the agreement can only be amended by vote of all of the shareholders, [38] allowing the minority shareholder to unilaterally block any efforts to change these arrangements.

Minority Business Enterprise Applications

A Section 488 Agreement can also be useful in instances where a service disabled veteran, woman, or minority individual (the "51% Shareholder") must own 51% of the equity and control the corporation. The agreement can be used to create a two-member board of directors (for example, the 51% Shareholder and a 49% shareholder), but allow the 51% Shareholder to have the controlling vote (usually by giving him or her two votes as a director). This avoids having to recruit additional qualified individuals who may not have any connection with, or special knowledge regarding, the corporation or its business. As this approach may not match the letter of the controlling regulations (which may require "a majority of the Board" to be comprised of qualified individuals), counsel should confirm that the certifying body would accept this approach.

Limited Duration Agreement

Although Section 488 Agreements are generally not limited in duration, counsel could craft an agreement with a specific term in certain circumstances—for example, if the intent of the agreement is to grant control to a certain investor until specific performance objectives are reached.[39]

Additional Provisions for Typical Buy-Sell Agreements

Even if the shareholders do not wish to generally alter the governance provisions of the MBCA, they may still wish to include one or more of the provisions specifically permitted by Section 488—such as director proxies, distributions not in proportion to share ownership (another opportunity to implement LLC-type aspects into the corporate form), weighted voting rights, and deadlock resolutions— into a more typical "buy-sell" type of shareholder agreement. As long as the requirements of Section 488 are met, the provision will be binding even though in conflict with other provisions of the MBCA.

Issues to Consider When Drafting a Section 488 Agreement

The following are issues to consider when drafting a Section 488 Agreement.

Consideration (and Customization) of Existing Articles, Bylaws, etc.

Counsel who engage in drafting a Section 488 Agreement must use care to make sure that the agreement works in harmony with existing governance documents, or that these documents are amended accordingly. It may be wise to include a provision in the Section 488 Agreement stating that, in the event of conflict between the agreement and the articles or bylaws, the agreement controls.[40] For example, if the agreement shifts the responsibilities of the board of directors to other persons, Section 488(6) imposes on such persons the liability for acts or omissions "imposed by law on directors to the extent that the discretion or powers of the directors are limited by the agreement."[41] The Section 488 Agreement "could also provide for exculpation from that liability to the extent otherwise authorized" by the MBCA.[42]

Although counsel will need to consider the impact of a Section 488 Agreement on relevant bylaw provisions, it should not be necessary for the drafter to attempt to modify every provision of the MBCA that might conflict with the provisions of a Section 488 Agreement, as "courts should in such cases construe all related sections of the Act flexibly and in a manner consistent with the underlying intent of the shareholder agreement."[43]

Articles, Bylaws, or Standalone Agreement?

Counsel will need to give some thought as to whether a Section 488 Agreement should be included in the bylaws, articles, or separate agreement; each option has advantages and disadvantages. For example, inclusion in a written agreement or bylaws allows the provisions to remain confidential.[44] On the other hand, placing these provisions in the articles could be viewed as public notice on the limitations of management and the like contained in the agreement. However, this might limit the entity's flexibility, as amendments to the articles must be filed before the Section 488 Agreement becomes effective.[45]

If the agreement is included in the articles or bylaws, counsel may wish to consider having each shareholder sign the document, or at least the resolution adopting the provisions. Although it is not necessary that the shareholders sign the document, "it may be desirable to have all the shareholders actually sign the instrument in order to establish unequivocally their agreement."[46] The same principle applies equally to transferees of the shares.[47]

Special Considerations for S Corporations

A Section 488 Agreement might be quite useful for shareholders of an S Corporation to allocate control of the corporation to certain shareholders without causing the corporation to have more than one class of stock (as forbidden by the Internal Revenue Code). To qualify as an S Corporation, a corporation may not have more than one class of stock.[48] Differences in voting rights among the shares of common stock do not cause a corporation to be treated as having more than one class of stock.[49] Treasury Regulations allow an S Corporation to have such features as voting and nonvoting common stock, a class of stock that is permitted to vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.[50] A corporation can implement one or more of these mechanisms without creating more than one class of stock for purposes of maintaining S Corporation status.[51] A Section 488 Agreement can be quite useful in implementing these mechanisms without having to amend the corporation's articles (the normal way of distinguishing between voting and non-voting shares). This is especially true if the corporation is looking for something other than an all-or-nothing approach to voting rights.

Counsel must ensure, however, that the Section 488 Agreement does not compromise each share's identical right to distribution and liquidation proceeds. For purposes of determining S Corporation status, a corporation has only one class of stock "if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds."[52] Determining whether all shares confer identical rights is based on the corporation's governing provisions, including its articles, bylaws, and any binding agreements relating to distribution and liquidation proceeds.[53] A Section 488 Agreement will clearly be part of any such determination. The drafter must avoid including language allowing distributions not in proportion to share ownership (as permitted under Section 488(1)(b)), which could jeopardize the corporation's S-election.

Section 488 Has Limits

Although Section 488 provides a great deal of flexibility to shareholders to craft their own governance rules—the comment to the Model Act provision states that the provision "validates virtually all types of shareholder agreements that, in practice, normally concern shareholders and their advisors"[54]—that flexibility is not limitless. Although it notes that "[f]urther development of the outer limits is left…for the courts,"[55] the commentary to the Model Act indicates that a few provisions would fail the public policy test noted above and would not be fair game for a Section 488 Agreement:

- An agreement that provides that the directors of the corporation have no duties of care or loyalty to the corporation or the shareholders. Such a provision is not very similar to the enumerated permitted arrangements and could be viewed as being contrary to public policy.[56]
- A provision that exculpates directors from liability more broadly than permitted by the MBCA, as public policy reasons support the existence of these limitations.[57]

Not Binding on Third Parties

The provisions of a Section 488 Agreement are not binding on third parties, including governmental entities and creditors.[58] The intent of Section 488 is to cover only "the relationship of shareholders and the corporation." [59] As such, an agreement provision that attempts to reorder the priority of payments upon dissolution of the corporation, or to waive the requirements of filing annual reports with the Department of Licensing and Regulatory Affairs, would be ineffective.[60]

What if Not Unanimous?

One treatise has noted that "the section leaves open the validity of any 488-type agreement that fails to satisfy its unanimity requirement," and hypothesized that "[i]f, for example, two out of three shareholders agree to limit board powers, a court might The Section 488 Agreement can only be amended by unanimous vote of the shareholders at the time of the amendment, unless the agreement provides otherwise. Sectio n 488 re visite d 15 consider whether the shareholder who neither approved nor signed the agreement was prejudiced by it and under appropriate circumstances might sustain the agreement."[61] However, the validity of such an agreement "is at best uncertain, and, if at all possible, counsel should attempt to bring such agreements within the safe harbor of section 488."[62]

Vote Required for Amendment

The Section 488 Agreement can only be amended by unanimous vote of the shareholders at the time of the amendment, unless the agreement provides otherwise.[63] Counsel should give careful thought to whether there is any reason to permit less than all of the shareholders to make a change. If the intent is to include a provision specifically permitted by Section 488 (such as director proxies) into a typical buy-sell type of shareholder agreement, it might be advantageous to opt out of the unanimous amendment requirement—but you must do so in the body of the agreement. If a unanimous vote is desired and the agreement is placed in the corporation's bylaws, it is prudent to include language in the agreement to that effect, "to avoid an argument that the majority vote provisions generally found in most bylaws constitute the statutory permitted agreement of the shareholders for amendment of the Section 488 agreement by less than a unanimous vote."[64]

Is the Corporation a Party to the Agreement?
While the corporation itself is not required by statute to be a party to the Section 488 Agreement, it may be wise to include it, as the corporation may be better situated to enforce the rights and remedies provided therein.[65] If the corporation is not included as a party, it should be granted the right to enforce the agreement.[66]

All Shareholders—Even Holders of Nonvoting Shares—Must Approve
Keep in mind that Section 488(2)(a) requires that a Section 488 Agreement be approved by "all persons who are shareholders at the time of the agreement"—whether or not those shareholders hold voting or non-voting shares.[67]

Conclusion

Section 488 remains a useful—if often overlooked—tool at the disposal of Michigan corporations and their counsel. Although the emergence of the limited liability company may have reduced the impact of Section 488 for creating an entity with flexible governance that can be determined by the entity's owners, the provision can be used by Michigan corporations seeking additional flexibility with respect to governance provisions without using or converting to an LLC.

NOTES

1. MCL 450.1488.
2. MCL 450.1101 *et seq.*
3. Senate Bill 414, House Legislative Analysis (June 3, 1997).
4. See James C. Bruno, *Business Problems and Planning--Shareholder and Joint Venture Agreements under Section 488 of the Michigan Business Corporation Act, 78* Mich. B.J. 72 (1999).
5. Stephen H. Schulman *et al.*, Michigan Corporation Law & Practice §4.21a (2010).
6. MCL 450.4101 *et seq.*
7. *See* New Business Entities, Michigan Department of Licensing and Regulatory Affairs, available at http://www.michigan.gov/lara/0,4601,7-154-35299_35413-114905--,00.html (last visited September 1, 2011) (between October 1, 1997 and September 30, 1998, 16,297 LLCs were organized or given certificates of authority to transact business in Michigan, as opposed to 25,909 corporations).
8. *Id.*
9. Schulman *et al., supra* note 5.
10. MCL 450.1488(1)(a).
11. MCL 450.1488(1)(b).
12. MCL 450.1488(1)(c).
13. MCL 450.1488(1)(d).
14. MCL 450.1488(1)(e).
15. MCL 450.1488(1)(f).
16. MCL 450.1488(1)(g).
17. MCL 450.1488(1)(h).
18. If a Section 488 Agreement is contained or referred to in a corporation's articles of incorporation or bylaws, and the agreement ceases to be effective for any reason, the board of directors may without shareholder action adopt an amendment to the articles of incorporation or bylaws to delete the agreement and any references to it. MCL 450.1488(5).
19. Incorporators or subscribers for shares may act as shareholders with respect to a Section 488 Agreement if no shares have been issued when the agreement is made. MCL 450.1488(2). Also note that Section 488(10) states that the failure to satisfy the unanimity requirement of Section 488(2) with respect to a Section 488 Agreement does not invalidate any agreement that would otherwise be considered valid.
20. MCL 450.1488(2).
21. The existence of a Section 488 Agreement may also be noted on an information statement required under Section 336(2). MCL 450.1488(3).
22. MCL 450.1488(3).
23. A purchaser has knowledge of the existence of a Section 488 Agreement at the time ownership is transferred if the agreement's existence is noted on the certificate or information statement in compliance with Section 488(3) and, if the shares are not represented by a certificate, the information statement is delivered to the purchaser at or prior to the time ownership of the shares is transferred. MCL 450.1488(3). 16 The Michigan Business Law Journal — fall 2011
24. An action to enforce the right of rescission must be commenced within 90 days after discovery of the Section 488 Agreement or 2 years after the shares are transferred, whichever is earlier. MCL 450.1488(3).
25. MCL 450.1488(6).
26. MCL 450.1488(7).
27. Model Bus. Corp. Act §7.32, cmt. at 7-62.
28. *Id.* at 7-64.
29. Bruno, *supra* note 4, at 73.
30. MCL 450.1488(7).
31. MCL 450.1488(1)(c).
32. MCL 450.1488(1)(d).
33. MCL 450.1488(1)(c) and (d).
34. MCL 450.1488(1)(c).
35. MCL 450.1488(1)(e).
36. MCL 450.1488(1)(b). Note, however, that any restrictions on dividends are subject to the provisions of Sections 345 and 855a of the MBCA pertaining to the protection of creditors. *Id.*
37. MCL 450.1488(1)(g).
38. MCL 450.1488(2)(b).
39. Bruno, *supra* note 4, at 74.
40. *Id.*
41. MCL 450.1488(6).
42. Model Bus. Corp. Act §7.32, cmt. at 7-68.
43. *Id*. at 7-64. For example, as noted in the commentary to the Model Act, "in the case of an agreement that provides for weighted voting by directors, every reference in the Act to a majority or other proportion of directors should be construed to refer to a majority or other proportion of the votes of the directors." *Id.*
44. Bruno, *supra* note 4, at 73.
45. *Id.*
46. Model Bus. Corp. Act §7.32, cmt. at 7-65.
47. *Id.*
48. 26 USC 1361(b)(1)(D).
49. 26 USC 1361(c)(4).
50. *See* Treas. Reg. 1.1361-1(l)(1).
51. *Id.*

52. Treas. Reg. 1.1361-1(l)(1).
53. Treas. Reg. 1.1361-1(l)(2)(i).
54. Model Bus. Corp. Act §7.32, cmt. at 7-63.
55. *Id.* at 7-64.
56. *Id.*
57. *Id.*
58. *Id*. at 7-62.
59. Schulman *et al., supra* note 5.
60. Model Bus. Corp. Act §7.32, cmt. at 7-64.
61. Schulman *et al., supra* note 5.
62. *Id.*
63. MCL 450.1488(2)(b).
64. Bruno, *supra* note 4, at 74.
65. *Id*.
66. *Id.*
67. Model Bus. Corp. Act §7.32, cmt. at 7-65.

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