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SENATE ANALYSIS SECTION

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Senate Bill 19 (Substitute S-3 as passed by the Senate)

Sponsor: Senator Dick Posthumus

Senate Committee: Commerce and Technology

Date Completed: 2-19-87

RATIONALE

In the past few years, the corporate world has been the scene of takeovers, re-organizations, mergers, and restructuring to prevent takeovers. As a result, some directors have had to act rapidly with little time to deliberate or gather information. Some people contend that under existing state law, directors and officers could be held personally liable for erroneous decisions that were made honestly and in good faith. Corporations usually have procured liability insurance for directors and officers to guard them against losses arising out of claims against directors and officers for which they are not indemnified by their corporation. Reportedly, however, directors and officers are facing a liability insurance crisis as the cost of this insurance has become prohibitively expensive, coverage has become very restrictive, and sources for the insurance are becoming scarce. If this situation continues, it is feared that Michigan-based corporations will face increasing difficulty in attracting persons to serve as directors or officers.

CONTENT

Senate Bill 19 (S-3) would amend the Nonprofit Corporation Act to allow corporations to limit the personal liability of directors, and to broaden the authority of corporations to indemnify directors and officers for claims and suits against them. The bill would do the following:

- Permit articles of incorporation to provide that a director would not be personally liable to a corporation or its shareholders for a breach of the director's duty except for specific actions, including intentional misconduct or a knowing violation of the law.
- Liberalize the authority of a corporation to indemnify an officer or director in a suit by or on behalf of the corporation.
- Allow a committee of at least two disinterested directors to authorize indemnification, if a quorum of disinterested directors were not obtainable.
- Allow indemnification agreements that were broader than the indemnification provided for in statute.

The bill would become effective on March 1, 1987.

Liability

Under the bill, a corporation's articles of incorporation could provide that a director was not personally liable to the corporation, its shareholders, its members, or others for monetary damages for a breach of the director's duty. Such a provision would not limit or eliminate the liability of a director for any of the following:

- Acts or omissions that were not in good faith or that involved intentional misconduct or knowing violation of law.

- A violation of the section of the act concerning directors' liability for corporate actions involving unauthorized dividends or distributions (MCL 450.1551(1)).
- A transaction from which the director derived an improper personal benefit.
- An act or omission that occurred before March 1, 1987.

Indemnification/Authorization

The Act currently authorizes a corporation to indemnify any person who is or was a party to, or is threatened with a pending or completed civil, criminal, administrative, or investigative suit or proceeding, because the person is or was a director, officer, employee or agent of the corporation, or serving at the request of the corporation as a director, officer, employee, or agent of another corporation, partnership, joint venture, trust, or other enterprise. A person may be indemnified for expenses (including attorneys' fees), judgments, fines, and amounts paid in settlement. Under the bill, indemnification would cover formal or informal suits or proceedings, persons serving at the request of the corporation as a partner or trustee of another corporation, and persons serving as a director, officer, etc., of another corporation or other enterprise, whether foreign or domestic or for-profit or not.

The Act provides that, in a suit by or in the right of a corporation, indemnification may not be made for any claim or matter in which the person was found liable for negligence or misconduct in the performance of his or her corporate duty unless the court finds, upon application, that the person is nevertheless entitled to indemnity. Under the bill, however, court approval would be required only if the person were found liable to the corporation (i.e., in cases of intentional misconduct, a breach of the duty of loyalty, etc., if liability were limited in the corporate articles).

The Act provides that, unless ordered by a court, indemnification may be made by the corporation only upon a determination that the indemnification is proper because the person met the standards of conduct established in the acts. Current methods for making this determination include: by a majority vote of a quorum of the board consisting of directors who were not parties to the suit or proceeding, by the shareholders, or by a written opinion of an independent legal counsel. The bill would allow another method: if a quorum of the board of directors excluding the parties were not obtainable, then by a majority vote of a committee consisting solely of directors who were not parties to the action. The committee would have to consist of at least two disinterested directors.

Indemnification Agreements

The bill specifies that the indemnification and advancement of expenses provided under the Act would not be exclusive

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of other rights to which a person seeking indemnification or advancement of expenses could be entitled under the articles of incorporation, bylaws, agreements, a vote of the shareholders, members, or disinterested directors, or otherwise.

These provisions would replace language under which 1) an indemnification provision, whether in the articles, the bylaws, a resolution, an agreement or otherwise, is invalid only to the extent that it conflicts with the Act and 2) nothing in the Act affects any rights to indemnification to which persons other than officers and directors may be entitled by contract or otherwise by law.

Other Provisions

The Act requires indemnification of expenses of a director, officer, employee, or agent who has been successful in defending any action against him or her in that corporate capacity. The bill would require indemnification also of expenses incurred in a proceeding brought to enforce this mandatory indemnification provision.

The bill specifies that if any person were entitled to indemnification under the Act for a portion of expenses (including attorneys' fees), judgments, penalties, fines, and settlements, but not for the total amount, the corporation could indemnify that person for the portion for which the person was entitled to be indemnified.

The Act already provides that expenses incurred in defending a suit may be paid by the corporation before the final disposition of the proceedings upon receipt of an undertaking by or on behalf of the director, officer, employee, or agent to repay the expenses if it is determined that the person is not entitled to indemnification. Under the bill, this undertaking would have to be by unlimited general obligation of the person on whose behalf the advances were made, but it would not have to be secured.

MCL 450.1541 et al.

BACKGROUND

Directors' Duties/Liability

Generally, corporate directors and officers possess similar duties and liabilities. Under common law, the duties of corporate directors and officers are the duty of loyalty and the duty of care. The duty of care, as a rule, has been interpreted to require corporate directors and officers to perform their duties in good faith, in the best interest of the corporation and in a manner that an ordinarily prudent person would use in similar circumstances. In addition to common law duties, corporation officers and directors also are responsible for fulfilling requirements imposed by statute.

Under Michigan's Business Corporation Act, a director or officer of a corporation is required to discharge the duties of his or her position in good faith and with the degree of diligence, care, and skill that an ordinarily prudent person would exercise under similar circumstances in a like position. Although the Act establishes a standard of care, Michigan case law also has held that directors may be liable for willful or negligent failure to perform their official duties. In particular, the Michigan Supreme Court ruled in 1928 in *Dinsmore v Jacobsen* (242 Mich 192) that corporation directors may be liable for negligent management and that the director's good faith alone is not an excuse for negligence. While the potential liability that corporate directors and officers face for violating common law or statutory duties can vary, the liability reportedly can be significant.

Comparable State Laws

Several states have acted recently to increase the protection from liability afforded to corporate officers and

directors in response to court judgments and the decreasing availability of insurance. Delaware has instituted a policy that gives shareholders the option of voting to include in their articles of incorporation a provision that limits or eliminates director liability for violations of the duty of care, but does not apply to violations of the duty of loyalty, breaches of faith, or other misconduct.

Virginia passed legislation that allows shareholders to adopt a provision in the articles of incorporation or a bylaw or resolution that provides for indemnification of directors for all but gross negligence or willful misconduct.

Indiana law provides that a corporation may choose to set its indemnification standards through: its articles of incorporation, resolution of its board of directors or of its shareholders, or any other authorization adopted after notice by a majority of the holders of all the voting shares issued and outstanding. In addition, a corporate director is not liable for his or her actions unless these actions constitute willful misconduct or recklessness.

Missouri law enables corporate boards of directors to decide to indemnify corporate officials beyond the scope of statutory allowances with or without shareholder approval.

FISCAL IMPACT

The bill would have no fiscal implications.

ARGUMENTS

Supporting Argument

Corporations need to obtain and retain their directors, officers, and "outside directors" who are not employees of the corporation but are recruited from the public and private sectors. These persons may be reluctant to serve on corporate boards if they feel exposed to personal liability. As a result, the quality of corporate governance may be reduced by the inability of the corporation to recruit competent persons, which could decrease the productivity of the corporation. Michigan corporations often are in competition with out-of-state corporations for managerial talent, and the lack of protection will not aid Michigan companies in recruiting quality directors. In addition, if Michigan directors do not feel protected from personal liability, they may be discouraged from vigorously fighting takeover attempts by out-of-state corporations.

Supporting Argument

The bill is necessary to protect the economic climate in Michigan. Without the proposed provisions, businesses may be tempted to reincorporate in another state, such as Delaware, whose law already allows corporate articles to provide limited immunity to directors and officers.

Response: The state of incorporation often has little or nothing to do with the actual location of a business. Because reincorporation need not involve the movement of corporate headquarters, a company may still be headquartered in Michigan and incorporated elsewhere. The only difference reincorporation would make is strictly a matter of perception.

Supporting Argument

Directors' and officers' insurance provides coverage when indemnification is not available. Yet, because this type of insurance is becoming scarce, another method of protecting directors and officers — such as broadening indemnification — is needed. This is a logical step to filling the gap left by disappearing insurance.

Supporting Argument

Allowing corporations to indemnify officers and directors from liability would increase the ability of third parties to obtain compensation for their injuries. Many directors on their own are not able to pay multi-million dollar judgments.

Opposing Argument

Insulating directors from liability would remove the checks and balances that motivate these persons to act properly, and would reduce their standard of care. If corporate officials were immune from liability, they would not be effectively discouraged from taking actions that were not in the best interest of their corporation but, instead, could be encouraged to violate their duties.

Response: In the first place, the bill would grant no automatic immunity, but would leave any limitation on liability up to the discretion of the shareholders. Secondly, the proposed protections would not eliminate all measures that ensure accountability, such as the threat of removal, demotion, or criminal liability that can result from improper conduct. Finally, a corporation's shareholders could modify the proposed immunity provision in a corporation's articles, in order to create additional exceptions to immunity; for example, the articles could specify that a director would remain liable for gross negligence.

Opposing Argument

Broader indemnification by a corporation would be sufficient to protect corporate directors' personal assets, without also limiting liability.

Response: Without the provisions limiting directors' personal liability, the problem of recruiting and retaining quality directors will remain. Even if directors' assets were protected, the individuals would still be subject to the negative exposure of a lawsuit.

Opposing Argument

It has been claimed that insurance costs for coverage against corporate directors' and officers' liability recently have risen drastically. In response to this situation, the bill proposes a qualified immunity from shareholder lawsuits. This reflects a disturbing development in the law: the provision of immunity from liability for groups who allege that they are experiencing difficulty in finding or affording insurance coverage, instead of addressing problems in the insurance industry that are at the root of this situation.

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.