



**House
Legislative
Analysis
Section**

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NONPROFIT CORPS: DIRECTOR LIABILITY

Senate Bill 19 (Substitute H-4)
First Analysis (10-22-87)

RECEIVED

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Sponsor: Senator Dick Posthumus

Senate Committee: Commerce & Technology

House Committee: Judiciary

Mich. State Law Library

THE APPARENT PROBLEM:

Among those for whom potential liability and the related problem of insurance availability are of increasing concern are directors and officers of nonprofit corporations. In these litigious times, many fear harassment by lawsuits and being held personally liable for faulty decisions that were made honestly and in good faith. Corporations sometimes obtain liability insurance for directors and officers to guard them against losses arising out of claims for which they are not indemnified by the corporation. Reports are, however, that directors and officers are facing a liability insurance crisis as the cost of the insurance has become more expensive, coverage restrictive, and sources for the insurance scarce. Nonprofit corporations rely heavily on volunteers and the vulnerability to lawsuits only makes it more difficult for nonprofits to attract good directors and officers. Public Act 1 of 1986 amended the Business Corporation Act to, among other things, allow those corporations to limit the personal liability of directors, and many argue that the Nonprofit Corporation Act should be similarly amended.

THE CONTENT OF THE BILL:

Senate Bill 19 (Substitute H-4) would amend the Nonprofit Corporation Act to allow nonprofit corporations to limit the personal liability of volunteer directors, and to broaden the authority of nonprofits to indemnify directors and officers for claims and suits against them. Charitable nonprofits eligible for federal tax exemption would be authorized to assign to the corporation all third party liability for acts and omissions of a volunteer director occurring on or after January 1, 1988. They and other nonprofit corporations could include in their articles of incorporation a provision that a volunteer director was not personally liable to the corporation, its shareholders, or its members for a breach of fiduciary duty. The bill would take effect January 1, 1988. A more detailed explanation follows.

Liability

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

- a breach of the director's duty of loyalty to the corporation, its shareholders, or its members;
- acts or omissions that were not in good faith or that involved intentional misconduct or knowing violation of law;
- a violation of the section 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 occurring before January 1, 1988, or that was grossly negligent.

A charitable nonprofit corporation's articles of incorporation could assign to the corporation all third party liability (that is, liability to any person other than the corporation, its shareholders, or its members) for all acts and omissions of a volunteer director occurring on or after January 1, 1988.

Indemnification/Authorization

The act 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 under the act. 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 would specify that the indemnification and advancement of expenses provided under the act would not be exclusive of other rights to which a person seeking them could be entitled under the articles of incorporation, bylaws, or a contractual agreement. However, the total amount of expenses advanced or indemnified from all sources combined could not exceed the amount of actual expenses incurred.

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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 would specify 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.

HOUSE COMMITTEE ACTION:

The House Judiciary committee adopted a substitute to Senate Bill 19 that differed from the Senate-passed version primarily in limiting liability protections to volunteer directors and in limiting third-party liability protections to volunteer directors of charitable nonprofits.

BACKGROUND INFORMATION:

The following background information was provided by the Senate Fiscal Agency in its analysis dated 2-19-87.

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 IMPLICATIONS:

According to a Senate Fiscal Agency analysis dated 2-19-87, the bill would have no fiscal implications.

ARGUMENTS:

For:

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. Directors and officers of for-profit corporations received protections similar to the bill's last winter, when Public Act 1 was enacted. Volunteer directors of nonprofit corporations perform a community service and deserve similar protections.

For:

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. Further, allowing corporations to indemnify officers and directors from liability would improve the ability of third parties to obtain compensation for their injuries. Few directors are able to pay judgments running into thousands of dollars.

Against:

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.

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. Second, the proposed protections would not eliminate all measures that ensure accountability, such as the threat of removal, censure, 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 exceptions to immunity in addition to those specified by the bill.

Against:

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.

Against:

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.

POSITIONS:

The Corporations and Securities Bureau of the Department of Commerce supports the bill. (10-21-87)

The Michigan Council on Crime and Delinquency supports the bill. (10-20-87)

The Michigan Electric Cooperative Association supports the bill. (10-20-87)

The Michigan Federation of Private Child and Family Agencies supports the bill. (10-21-87)

The Michigan Interfaith Council on Alcohol Problems supports the bill. (10-20-87)

The Michigan Petroleum Association supports the bill. (10-20-87)