House
Legislative
Analysis
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INSURANCE DIRECTORS' LIABILITY

Senate Bill 38 with House committee amendments
Second Analysis (6-8-88)

Sponsor: Sen. Dick Posthumus
Senate Committee: Commerce & Technology
House Committee: Judiciary

THE APPARENT PROBLEM:

Some people contend that under existing state law, directors and officers of insurance corporations 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 the 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.

THE CONTENT OF THE BILL:

The bill would amend the Insurance Code to repeal and replace provisions that address the standard of care, indemnification, and personal liability of insurance corporation directors. The bill would do the following:

- Permit articles of incorporation to provide that a director of aninsurance corporation would not be personally liable to the corporation or its shareholders or policyholders for a breach of fiduciary duty except for specific actions, including intentional misconduct or a knowing violation of the law.
- In a suit by or in the right of the corporation, require court approval of indemnification of a director found liable to the corporation.
- Specify methods for determining whether indemnification were proper.
- Allow indemnification agreements that were broader than the indemnification provided for in statute.

The bill would take effect January 1, 1989. A more detailed description follows.

Liability. The bill would require a director or an officer to discharge the duties of his or her position "in good faith and with that degree of diligence, care, and skill which an ordinarily prudent person would exercise under similar circumstances in a like position" (which is very similar to the current standard of care [MCL 500.5293]). In discharging the duties of the position, the director or officer could rely upon any of the following:

- The opinion of legal counsel for the corporation.
- The report of an independent appraiser selected "with reasonable care" by the board of directors.
- Financial statements of the corporation represented to him or her ascorrect by the president or the officer of the corporation having charge of its accounts.
- Financial statements of the corporation in a written report by an independent public or certified public accountant.

The bill would allow an insurance corporation's articles of incorporation to provide that a director was not personally liable to the corporation or its shareholders or policyholders for monetary damages for a breach of the director's fiduciary duty. Such a provision would 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 or its shareholders or policyholders (that is, the duty of a director not to pursue his or her own interests to the disadvantage of the corporation).
- Acts or omissions that were not in good faith or that involvedintentional misconduct or knowing violation of law.
- A violation of the section of the code concerning directors' liability for debts during organization (MCL 500.5036) or for a deficiency in capital and assets upon accepting new risks (MCL 500.5276 and 500.5280).
- A transaction from which the director derived an improper personal benefit.
- An act or omission that occurred before March 1, 1987.

Indemnification/Authorization. Current law, which would be repealed, permits the indemnification of a director, officer, or employee for expenses and liabilities arising out of a criminal or civil action. Indemnification is prohibited if the person is guilty of a breach of duty, unless the person acted in good faith for a purpose he or she reasonably believed to be in the insurer's best interest. The determination of whether a person met the standard for indemnification must be made by attorneys of reciprocal insurers, a majority of the policyholders of mutual insurers, the holders of a majority of outstanding shares, or a court. (MCL 500.5243)

The bill would authorize an insurance corporation to indemnify any person who was a party to, or was threatened with, a pending or completed civil, criminal, administrative, or investigative suit or proceeding, whether formal or informal, because the person is or was a director, officer, employee, or agent of another corporation, partnership, joint venture, trust, or other enterprise, whether foreign or domestic or for-profit or not. A person could be indemnified for expenses (including actual and reasonable attorneys' fees), judgments, penalties, fines, and amounts paid in settlement, if the person acted in good faith in a manner he or she believed to be in, or not opposed to, the best interests of the corporation or its shareholders or policyholders and had no reasonable cause to believe the conduct unlawful. The termination of an action by judgment, order, settlement, or conviction, or upon a plea of nolo contendere, would not create a presumption that the person failed to act in "good faith."

In a suit by or in the right of a corporation, indemnification could be made against expenses and amounts paid in settlement if the person acted in "good faith" and in a

OVER

manner he or she thought to be in, or not opposed to, the best interests of the corporation or its shareholders or policyholders. Court approval for indemnification would be required, however, if the person were found liable to the corporation (i.e., in cases of an intentional misconduct, a breach of the duty of loyalty, etc., if liability were limited in the corporate articles).

The bill provides that, unless ordered by a court, indemnification coul be made by the corporation only upon a determination that the indemnification was proper because the person met the standards of conduct established in the bill. Methods for making this determination would include:

- By a majority vote of a quorum of the board consisting of directors who were not parties to the suit or proceeding.
- If a quorum of the board of directors were not obtainable, then by a majority vote of a committee that consisted of at least two disinterested directors.
- By a written opinion of an independent legal counsel.
- By the shareholders or policyholders.

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

Other Provisions. The bill would require 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.

If any person were entitled to indemnification under the bill's provisions for a portion of expenses (including actual and reasonable 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 bill provides that expenses incurred in defending a suit could 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. The bill would require that undertaking to be by unlimited general obligation of the person on whose behalf the advances were made, but it would not have to be secured.

The bill specifies that "corporation" would include all constituent corporations absorbed in a consolidation or merger, so that a person who was a director, officer, employee, or agent of the constituent corporation would stand in the same position with respect to the resulting or surviving corporation as the person would if he or she had served that corporation in the same capacity.

The bill also would delete a provision of the code that permits an insurer to reimburse an officer or director for expenses in defending a proceeding against the person in his or her corporate capacity, unless the person is found liable for negligence or misconduct toward the insurer.

MCL 500.5008 et al.

HOUSE COMMITTEE ACTION:

The House Judiciary Committee adopted an amendment to delay the effective date of the bill from March 1, 1987 to January 1, 1989. The action taken on June 7, 1988, was the second time the committee reported the bill out. On December 8, 1987, the committee reported the bill with an effective date of January 1, 1988. The House sent the bill back to committee on February 16, 1988.

FISCAL IMPLICATIONS:

According to the Senate Fiscal Agency, the bill would have no fiscal implications for either the state or local units of government. (2-18-87)

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, 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.

For:

The bill is necessary to protect the economic climate in Michigan. Without the proposed provisions, insurance businesses may be tempted to reincorporate in other states whose laws already allow 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.

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.

For:

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.

Against:

Insulating directors from liability would remove the checks and balances that motivate them 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. Moreover, if directors are to

MORE

receive the sort of statutory consideration that the bill proposes, there should be complementary statutory assurances that consumers and others who lack positions of authority are sufficiently protected through measures such as statutory requirements for plain language in contracts. The loss of one means of accountability should at least be balanced by the establishment of another.

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.

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 would remain. Even if directors' assets were protected, the individuals would still be subject to the negative exposure of a lawsuit.

Against:

This bill 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.

Against:

Under the House committee amendments, the bill would take effect January 1, 1989. However, the bill would retain a provision in the Senate-passed bill that says that a liability limitation in articles of incorporation would not limit the liability of a director for an act or omission occurring before March 1, 1987, which was the effective date under the Senate-passed bill. To be consistent and to ensure that newly-authorized liability protection does not predate the effective date of the bill, the March 1 date should be changed to January 1, 1989.

POSITIONS:

The Insurance Bureau supports the bill. (6-8-88)

The Michigan Insurance Federation supports the bill. (6-7-88)

The Michigan Citizens Lobby opposes the bill until such time as insurance companies are required by law to use plain language in their contracts. (6-7-88)