SAS SENATE ANALYSIS SECTION

Lansing, Michigan 48909

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**Senate Bill 39** (Substitute S-3 as passed by the Senate)
**Sponsor: Senator Dick Posthumus**
**Committee: Commerce and Technology**
**Date Completed: 3-6-87**

## *RATIONALE*

Some people contend that under existing state law, directors and officers of banks and safe and collateral deposit companies could be held personally liable for erroneous decisions that were made honestly and in good faith. The Banking Code currently does not explicitly authorize the procurement of liability insurance for directors and officers to guard them against losses arising out of liability claims. Consequently, some contend, such authorization should be granted; personal liability for directors should be limited; and indemnification provisions should be broadened. If these concerns are not addressed, it is feared that Michigan-based financial institutions will face increasing difficulty in attracting persons to serve as directors or officers.

## *CONTENT*

**Senate Bill 39 (S-3) would amend the Banking Code to limit the personal liability of bank and safe and collateral deposit company directors; broaden the authority of banks and deposit companies to indemnify directors and officers for claims and suits against them; and expressly permit banks and deposit companies to purchase and maintain insurance or create trust funds to protect against the liability of their directors, officers, employees, or agents. The bill would do the following:**

- **Permit articles of incorporation to provide that a director of a bank or a safe and collateral deposit company would not be personally liable to a bank or deposit company or its shareholders for a breach of fiduciary duty except for specific actions, including intentional misconduct or a knowing violation of the law.**
- **Grant authority to a bank or a safe and collateral deposit company to indemnify an officer, director, employee, or agent named in a suit because of his or her position with the bank or company.**
- **Specify methods for determining whether indemnification were proper.**
- **Allow indemnification agreements that were broader than the indemnification provided for in statute.**

The bill would become effective on March 1, 1987.

Liability

The bill would require a director or an officer of a bank or safe and collateral deposit company 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". 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 bank or deposit company.
- The report of an independent appraiser selected "with reasonable care" by the board of directors, or an officer, of the bank or deposit company.
- Financial statements of the bank represented to him or her as correct by the president or officer having charge of the bank's or deposit company's accounts.
- Financial statements of the bank or deposit company in a written report by an independent public or certified public accountant.

Any action against a director or officer for failure to discharge his or her duties would have to be commenced within three years after the cause of action or within two years after the time the cause of action was discovered, or should reasonably have been discovered, by the complainant, whichever occurred first.

The bill would allow a bank's or safe and collateral deposit company's articles of incorporation to provide that a director was not personally liable to the corporation or its shareholders 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 bank or deposit company or its shareholders.
- Acts or omissions that were not in good faith or that involved intentional misconduct or knowing violation of the law.
- A violation of the section of the Code concerning removal from office (MCL 487.343).
- 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 the bill would replace, permits a bank to indemnify a person for expenses and liabilities arising out of a civil or criminal proceeding in which the person was involved due to his or her position with the bank. Indemnification is prohibited if the person was guilty of a breach of duty unless he or she acted in good faith for a purpose reasonably believed to be in the bank's best interests. The determination of whether the person met the standard for indemnification may be made only by the holders of a majority of outstanding shares or by a court.

Under the bill, a bank or a safe and collateral deposit company could 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, partner, trustee, employee, or agent of another bank, national banking venture, trust, or other enterprise, whether for-profit or not. A person could be indemnified for expenses (including actual and reasonable attorneys' fees), judgments, penalties, fines, and amounts paid in

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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 bank or safe and collateral deposit company or its shareholders, and had no "reasonable cause" to believe the conduct unlawful. The termination of an action by judgment, order, settlement, conviction, or upon a plea of nolo contendere would not create a presumption that the person failed to act in "good faith".

The bill provides that, in a suit by or in the right of a bank or safe and collateral deposit company, indemnification could be made against expenses and amounts paid in settlement if the person acted in "good faith" and in a manner he or she thought to be in, or not opposed to, the best interests of the bank or deposit company or its shareholders. Court approval would be required for indemnification, however, if the person were found liable to the bank or deposit company (i.e., only in cases of an intentional misconduct, a breach of the duty of loyalty, etc., if liability were limited in the corporate articles).

Unless ordered by a court, indemnification could be made by the bank or safe and collateral deposit company only upon a determination that the indemnification was proper because the person met the standards of conduct established in the bill. Methods for making such a 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.

Indemnification Agreements

The bill specifies that the indemnification and advancement of expenses provided or granted under the bill would not be considered exclusive of any other rights to which persons seeking indemnification or advancement of expenses would 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. The indemnification provided for in the bill would continue as to a person who ceased to be a director, officer, employee, or agent and would inure to the benefit of the person's heirs, executors, and administrators.

Insurance

The bill would grant authority to banks and safe and collateral deposit companies to purchase and maintain insurance, including insurance issued by affiliated insurers and insurance for which premiums could be adjusted retroactively based upon claims experience. A bank or deposit company could also create a trust fund or other form of funded arrangement on behalf of a director, officer, employee, or agent against liability arising out of his or her capacity with the bank or deposit company, whether or not the bank had the power to indemnify him or her against liability.

Other Provisions

The bill would require indemnification of expenses of a director, officer, employee, or agent who had been successful in defending any action against him or her in that 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 for a portion of expenses (including actual and reasonable attorneys' fees), judgments, penalties, fines, and settlements, but not for the total amount, the bank or deposit company could indemnify that person for the portion of the expenses to which he or she was entitled to be indemnified.

Expenses incurred in defending a suit could be paid by the bank 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 were determined that the person was not entitled to indemnification. The bill would require that this undertaking 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 "the bank" would include all banks that became related to the bank by an acquisition, consolidation, or merger, and that a person who was a director, officer, employee, or agent of the bank would stand in the same position with respect to the resulting or surviving bank as he or she would if he or she had served that bank in the same capacity. (The bill includes a similar specification for safe and collateral deposit companies.) "Other enterprises" would include employee benefit plans; "fines" would include excise taxes assessed on a person with respect to an employee benefit plan; and "serving at the request of the bank [or deposit company]" would include service as a director, officer, employee, or agent of the bank that imposed duties on, or involved services by, the person with respect to an employee benefit plan, its participants, or beneficiaries; and a person who acted in good faith and in a manner he or she reasonably believed to be in the interest of the participants and beneficiaries of an employee benefit plan would be considered to have acted in a manner "not opposed to the best interests of the bank [or deposit company] or its shareholders".

MCL 487.401 et al.

## *FISCAL IMPACT*

The bill would have no fiscal implications for either the State or local units of government.

## *ARGUMENTS*

### *Supporting Argument*

Banks and deposit companies need to obtain and retain their directors, officers, and "outside directors" who are not employees but are recruited from the public and private sectors. These persons may be reluctant to serve on boards if they feel exposed to personal liability. As a result, the quality of governance of a bank's or deposit company's affairs may be reduced by the inability of the financial institution to recruit competent persons, which could decrease productivity. Lack of protection could hinder Michigan-based banks and deposit companies in recruiting quality directors.

### *Supporting Argument*

The bill is necessary to help protect the economic climate in Michigan. Without the proposed provisions, banks and deposit companies would be discouraged from incorporating in Michigan.

### *Supporting Argument*

The bill would expressly allow banks and deposit companies to purchase insurance to provide coverage for directors and officers 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, as

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well. This is a logical step to filling the gap left by disappearing insurance.

## *Supporting Argument*

Allowing officers and directors to be indemnified 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 banking officials were immune from liability, they would not be effectively discouraged from taking actions that were not in the best interest of their institution 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, shareholders could modify the proposed immunity provision in a bank's or deposit company'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 provisions would be sufficient to protect 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.

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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.