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SURVIVING THE DIRECTORS' AND OFFICERS' LIABILITY CRISIS: INSURANCE AND THE ALTERNATIVES

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Corporate America, like the ordinary individual, has relied upon the availability of insurance as *the* means of protecting its exposure to liability claims arising from the use of its vehicles, the quality of its products and services and errors or misconduct by its directors and officers. Although the cost of insurance in general has risen dramatically during the last two years, the basic ability to purchase any or adequate directors' and officers' (D&O) insurance has perhaps been the most profoundly affected area of liability insurance. The diminishment of insurance protection has been accompanied by an equally dramatic increase in the frequency, variety, and severity of claims being made against directors and officers.[1]

This article examines the causes and effects of the insurance "crisis" and the attendant increase of liability exposure. The basic protection afforded by D&O insurance as well as the alternatives and supplements to insurance are discussed and analyzed. Finally, particular loss prevention techniques are considered. Although the problems are identifiable, there are no easy or clear solutions.

I. THE D&O LIABILITY INSURANCE "CRISIS"

A. *State of the Market*

The availability, price, and extent of coverage of D&O insurance has been undergoing a dramatic, if not revolutionary, change in the

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1. HEIDRICK & STRUGGLES, INC., THE CHANGING BOARD (1986). Heidrick and Struggles, Inc. is an executive search firm with offices throughout the United States and Western Europe. The firm has conducted and published annual surveys of *Fortune* 1000 chairmen of boards since 1966.

last two years. In 1984, the Wyatt Company conducted a Directors' and Officers' Liability Survey to aid businesses in reaching decisions concerning the purchase of directors' and officers' insurance. The report, issued in October of 1984, identified eight leading insurers.[2]

Less than a year later, an interim report from the Wyatt Company indicated a markedly changed market.[3] Premium cost for the primary coverage was reported to have more than doubled. Primary limits were reported as having been reduced over 30% while deductibles were increased over 200%. Not only did the cost for excess coverage quintuple, but the coverage limits were dramatically reduced.

Noting the major influence of the London market in both reinsurance and excess coverage, in the spring of 1985 *Fortune* magazine quoted Robin Jackson, director of the Merrett Syndicate in London, one of the principal reinsurers and excess insurers, as stating, "In my view, putting the prices up 300 percent or 400 percent would only just be adequate."[4] *Fortune* also reported that the median policy limit of $25 million of the preceding year had already been reduced to $15 million. Those companies which had $200 million in coverage similarly found their limits reduced by approximately 50%.

Mr. Jackson's projections proved to be reasonably correct. By the late summer of 1985, a survey of corporations disclosed an increase in the annual cost of coverage of up to 500% over the preceding year.[5] Although the cost of the product created concern,

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2. THE WYATT COMPANY, 1984 COMPREHENSIVE REPORT: DIRECTORS & OFFICERS LIABILITY SURVEY (1984). The eight companies identified are:

American International Group (National Union)
Chubb Group (Federal)
CNA Continental Group (Harbor)
Crum & Forster (International Surplus Lines)
First State (A Hartford Group Subsidiary)
St. Paul Fire & Marine Insurance Company
Wausau Group (Employers of Wausau)

Id. at 127-34.

The Wyatt Company, based in Chicago, Illinois, is "an international consulting firm specializing in pension plans, actuarial evaluations, risk management, employee benefits and executive compensation."

3. THE WYATT COMPANY, 1985 SUPPLEMENTARY REPORT ON DIRECTOR & OFFICERS LIABILITY INSURANCE (1985). The 1985 report supplements the more comprehensive 1984 survey by updating significant changes relating to policy limits, deductibles, and premiums.

4. Newport, *Protecting Directors Suddenly Gets Costly*, FORTUNE, Mar. 18, 1985, at 61.

5. Taravella & Shapiro, *Psst . . . Do You Know a D&O Insurer?*, BUS. INS., July 29, 1985, at 1.

the lack of availability was more troublesome. The major reduction in excess reinsurance was attributed to a loss in surplus which manifested in a change in limits among the major insurers.[6] Most major insurers were offering only half of the limits available the year before. For example, L.W. Biegler, the underwriter for Crum & Forster, reported that capacity in all professional liability lines was substantially cut from $20 million to $5 million.[7] Harbor Insurance Company reported that its limits were reduced from $10 million to $5 million. Although the market is becoming more competitive, capacity is still severely limited as compared with prior years.[8] Because most insurers will be renewing their reinsurance treaties in early 1987 and seeking further excess capacity, market changes will likely be relatively minor.

Although some consumers perceive the present situation as a conspiracy or deliberate manipulation, the answer lies in the vintage analysis about supply and demand. The common response concerns a lack of "capacity." Capacity is the surplus of an insurance company available for underwriting, that being the difference between the company's assets and liabilities. In calculating surplus, insurers typically include loss experience, usually allocating for incurred but unpaid losses on a reserve basis. The amount of insurance which can be written by a company is regulated either by good sense or specific state insurance requirements to be based upon a ratio of surplus to premium, typically being one to two or one to three. Thus, for every dollar of surplus, an insurer can write $2 or $3 (sometimes $4) of insurance.

A loss in capacity to underwrite by the various insurers caused a diminishing surplus, which led to continued predictions of higher premium quotations, lower limits, and coverage unavailability.[9] In the extreme, the loss of surplus had other consequences. In April 1986, Midland Insurance Company, a previously active writer of directors' and officers' coverage, without prior warning, was placed in receivership and liquidated for insolvency.[10] Thus, the "insurance crisis" was as real for the insurance industry as for the consumer.

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6. *Id.* at 29.

7. *Id.*

8. Taravella, *Alternative Facilities Easing D&O Market*, BUS. INS., Oct. 20, 1986, at 26 [hereinafter Taravella, *Alternative Facilities*].

9. McInerney, *D&O: Down & Out*, BEST'S REV., Aug. 1985, at 48.

10. *In re* Liquidation of Midland Ins. Co., No. 41294 (N.Y. Apr. 3, 1986) (Order of Liquidation).

In looking for answers and solutions, the directors' and officers' insurance dilemma should be kept in perspective. D&O coverage is but one form of professional liability insurance. Virtually every profession has an extensive liability insurance program tailored to its particular needs. Together, these forms of professional insurance comprise a relatively small portion of the liability coverages written. The impact on costs and availability of insurance has cut across all liability lines and has received extensive national publicity.[11]

The liability industry in general suffered significant losses on behalf of their insureds which were not offset by very low premiums, with the consequence of greatly reducing surplus. The losses suffered in the professional liability lines in particular seemed to magnify the severity of the problems of the industry. The decade of the 1970s was truly a developmental era for professional liability claims, starting from a relatively low frequency and severity to a virtually explosive situation in the early 1980s.[12] Correspondingly, much of the significant case law on liability for directors, officers, lawyers, and accountants has only been decided within the last ten years.

Although the professional liability insurers could detect increases in frequency and severity in claims by the late 1970s, interest rates had increased substantially, and the attraction of writing professional liability insurance for its relatively large premiums was still appealing. The entry into the 1980s saw what can appropriately be described as "cash flow" underwriting.[13] Many underwriters admittedly recognized that the premium was inadequate for the risk, but the continued high interest rates on investments and the belief that frequency and severity would remain relatively constant, prompted severe price competition. Most insurers were extravagantly wrong on their projections of frequency and severity. Few professional liability insurers reported profits in the early 1980s, and many suffered severe losses. Reserves were typically inadequate, which, when adjusted, resulted in a severe contraction of surplus.[14]

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11. *See, e.g.*, Church, Constable, Leavitt & Riley, *Sorry, Your Policy is Canceled*, TIME, Mar. 24, 1986, at 16; Gest & Work, *Sky-High Damage Suits*, U.S. NEWS & WORLD REPORT, Jan. 26, 1986, at 35.

12. *See, e.g.*, Thompson, *Insurance on the Rocks*, 15 THE BRIEF 14, 17 (1986). The average lawyers' professional liability claim was reported to have increased from $5,000 in 1970 to $75,000 by 1985. *Id.*

13. Galante, *Malpractice Rates Zoom*, Nat'l L.J., June 3, 1985, at 1, col. 1 & at 25, col. 3 [hereinafter Galante].

14. *E.g.*, *Liability Insurance Picture Marked by Unpredictability*, Legal Times, Apr. 14, 1986, at 9, col. 1; Galante, *supra* note 13, at 1, col. 1.

The losses in surplus have been accompanied by a restriction in the reinsurance market. The reinsurers found the professional liability market unpredictable and risky; and, with their diminished capacities, sought safe harbor in other liability lines.

A continuing factor in the diminished market is still apparent increases in the frequency and severity of claims. These unpredictable increases created insecurity about whether the insurance product could be adequately priced. The severity of losses follows a judicial trend to liberalize exposure under the federal securities laws, state Blue Sky laws, and the newly discovered RICO statute.[15] In part, economic factors influence both insurance premiums and liability losses. When investors prospered, few complained about profits which could have been greater. As the economy turned downward in the 1980s, corporations and investments failed, tax benefits were challenged as abusive tax shelters by the Internal Revenue Service, and profits turned into losses. Lawsuits resulted and contingent liabilities became insurance losses.

Ironically, simply increasing the price of insurance does not aid, but immediately worsens, the availability problem. As noted, the amount the total premium written by a company is a multiple of surplus. If, for example, the price of a policy is doubled, then an insurer, for the same amount of premium, can write only half as many insureds. The ability to write more insureds requires a lowering of price or an increase of surplus. That requires either an influx of capital from a parent company or other source, a reduction of losses such as those created by over-reserving, or the more gradual increase of surplus when today's premium becomes tomorrow's profit. The last situation, the one most likely to occur, will simply take time, and therein lies the reason why improving availability has no short-term solution. For example, statutory caps on liability which reduce insurance payouts are likely to have only long-term effects.

The problems for corporations are immediate and serious, the most obvious of which is the inability to obtain adequate insurance for potential losses. A collateral but significant effect is the unwillingness of qualified persons to sit on corporate boards which are either uninsured, inadequately insured or otherwise unable to pay for a defense, making the director's own assets an attractive target

15. The Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1961 (1982).

for the claimant.[16] Young or aggressive corporations, in particular, which require capable and seasoned management, may be especially vulnerable.

II. THE D&O POLICY

A. *Nature of the Coverage*

Most policies derive from one of two Lloyd's standard forms, the more modern version being "Lydando No. 1," which was issued in 1976. In today's restrictive market, the form is undergoing constant revision.[17] Directors' and officers' liability insurance typically affords protection to the company's directors and officers for a "wrongful act" which arises from their conduct in their capacities as directors and officers of the company.[18] A second form, commonly available and known as "company reimbursement" coverage, repays to the corporation sums paid to indemnify its officers and directors.[19]

The following discussion examines the provisions of the policy and the case law which has construed the various forms. Although the discussion of case law is comprehensive of decisions concerning directors' and officers' coverage, it is not intended to be exhaustive of all applicable legal principles. The purpose is to provide a fundamental understanding of the D&O policy form, the interpretation of which is governed by case law pertaining to professional liability policies in particular and liability coverages in general.

B. *The Application*

The information contained in the application is the primary basis upon which an insurer decides whether to issue coverage, and for what price. Affirmative misrepresentations or material omissions have given rise to a significant body of coverage litigation. The focus of the litigation concerns a relatively standard inquiry in the application: "Does any Director or Officer have knowledge or information of any act, error, or omission which might give rise to a claim under

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16. Galante, *Corporate Boardroom Woes Grow*, Nat'l L.J., Aug. 4, 1986, at 1, col. 3; Silas, *Risky Business*, A.B.A. J., June 1, 1986, at 24.

17. *See* Hinsey, *The New Lloyd's Policy Form for Directors' and Officers' Liability Insurance—An Analysis*, 33 BUS. LAW. 1961 (1978) [hereinafter Hinsey, *New Policy Form*]. *See also* Shapiro v. American Home Assurance Co., 584 F. Supp. 1245 (D. Mass. 1984).

18. Hinsey, *New Policy Form*, *supra* note 17, at 1962.

19. *Id.*

the proposed policy?"[20]

The prior knowledge inquiry is especially pertinent to professional liability insurance in general.[21] Professional liability claims contrast sharply with general liability claims where the misconduct and injury are usually simultaneous. A professional liability claim, including claims against directors and officers, can arise out of an act or omission whose causative effect may take months or years to manifest in damages or a claim. Identifying preexisting acts and omissions which can give rise to future claims avoids insuring a risk for which no adequate premium can be received, akin to the aphorism, "Where there is smoke, there is fire."

In some of the litigation, insureds have sought to require the insurers to establish the materiality of both the questions and the answers. The courts have found materiality in either the fact that the question was asked or from its obvious, logical significance, concluding that the prior knowledge of a potential claim is assumed to be material to issuing a directors' and officers' policy. A disclosed circumstance is not covered.[22]

Although the purpose of the question may be obvious, the issue of materiality may concern the accuracy of the answer. For example, a 1980 Illinois district court decision examined responses which not only denied any act, error or omission which could give rise to a claim but also failed to distinguish between the insured's not-for-profit self and its for-profit affiliates.[23] There were disputed issues of fact which precluded summary judgment for the insurer about whether the policy should be declared void *ab initio* or whether it still provided coverage. The court was able to decide, however, based upon the materiality of the misrepresentation, that the insurer's denial of coverage was neither vexatious nor unreasonable.[24]

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20. *E.g.*, National Union Fire Ins. Co. v. Continental Ill. Corp., 643 F. Supp. 1434 (N.D. Ill. 1986); F/H Indus., Inc. v. National Union Fire Ins. Co., 635 F. Supp. 60 (N.D. Ill. 1986); Jaunich v. National Union Fire Ins. Co., No. C85-0055 EFL (N.D. Cal. May 27, 1986); National Union Fire Ins. Co. v. Seafirst Corp., No. C-85-396R (W.D. Wash. Mar. 18, 1986); Shapiro v. American Home Assurance Co., 584 F. Supp. 1245 (D. Mass. 1984); Automotive Wholesalers of Ill. v. National Union Fire Ins. Co., 501 F. Supp. 1205 (N.D. Ill. 1980); Zaremba v. National Union Fire Ins. Co., 1979 Fire & Casualty Cas. (CCH) 1302 (N.D. Ohio 1979).

21. R. MALLEN & B. LEVIT, LEGAL MALPRACTICE § 702 (2d ed. 1981) [hereinafter MALLEN & LEVIT] (The Policy—The Declaration Page).

22. *Id.*

23. Automotive Wholesalers of Ill. v. National Union Fire Ins. Co., 501 F. Supp. 1205 (N.D. Ill. 1980).

24. *Id.* at 1212-13.

A misrepresentation in response to the prior knowledge inquiry can void coverage. For example, in a 1984 Massachusetts decision, the president of a corporation signed an application in 1972 stating that he was unaware of any act, error, or omission which could give rise to a claim. The falsity of that statement became apparent when, in 1977, he was indicted and, in 1978, convicted for conduct in 1972 which consisted of filing a false financial statement.[25]

A related issue concerns whether the invalidation of the policy applies to other directors and officers who were innocent of knowledge of the wrongdoing at the time of the application. The application question typically inquires of the knowledge of "any" director or officer. From the insurer's perspective, the existence of circumstances which may give rise to a claim is *the* risk to be avoided. The insurer's concern is not principally with the honesty of the directors and officers, but the prospect of a likely claim. Moreover, avoiding liability on behalf of one officer or director does little to avoid the same exposure of others either directly or vicariously. One rationale for binding all is that the officer signing the false statement is acting as an agent on behalf of the others.[26] The agency rationale would have to be upon the apparent authority that the individual who signs does so on behalf of all. It is unlikely that an actual agency relationship exists with other officers and directors, particularly subordinates.[27]

Analysis, however, need not depend upon agency or ratification but contract interpretation. The application, in inquiring about prior knowledge, sets forth a contractual standard.[28] As a contract, a present warranty does not apply to a renewal application which simply incorporates a prior statement regarding the insured's knowledge. The warranty on the incorporated application applies only to the facts and circumstances at the time the warranty was originally made.[29]

A different conclusion may result where the person signing the application is not knowledgeable about the acts, errors, or omissions which can give rise to the claim. For example, a 1978 Ohio decision

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25. Shapiro v. American Home Assurance Co., 584 F. Supp. 1245 (D. Mass. 1984) (finding of deliberate misstatement concerning income with intent to defraud).

26. *See* Bird v. Penn Cent. Co., 334 F. Supp. 255 (E.D. Pa. 1971), *on hearing*, 341 F. Supp. 291 (E.D. Pa. 1972) (policy cancellation allowed for agent's false responses).

27. *See, e.g.*, *Shapiro*, 584 F. Supp. at 1251-52.

28. *Id.* at 1252.

29. National Union Fire Ins. Co. v. Continental Ill. Corp., 643 F. Supp. 1434 (N.D. Ill. 1986).

involving a National Union policy form contained the following attestation above the signature line: "The undersigned authorized officer of the financial institution declares that to the best of his knowledge the statements set forth herein are true."[30] The signator did not know that the financial statement of the company was inaccurate or that other officers and directors were aware of potential claims. The court concluded that the insurer, having asked for the truth of the statements "to the best of his knowledge," could not complain that the statements, albeit honest, were inaccurate.[31]

That result should not follow where the coverage involved is the more modern claims-made form which contains the prior knowledge limitation as either a provision in the insuring agreement or in an exclusion. Sometimes the prior knowledge limitation appears in the application as an exclusion for coverage for a claim arising from circumstances which should reasonably be known by any director or officer to be likely to give rise to a claim at the time of signing the application.[32] The analysis of such provisions then is simply a matter of interpreting the contractual provisions of the policy.

Other questions pertain to registration statements filed with the Securities and Exchange Commission, contemplated filings, and financial information. The legal effect of attached copies of a prospectus or financial statement depends upon the verbiage of the application. Thus, if the application does not extend the insured's warranty of truthfulness to attached documents, the insurer has no contractual basis upon which to claim that the attachments constitute material misrepresentations.[33]

Avoidance of the policy on the basis of misrepresentations in the application can be defended by the doctrines of waiver or estoppel. Waiver requires affirmative conduct indicating a conscious relinquishment of a known right,[34] or an acknowledgment of the presence of facts so as not to warrant raising a coverage issue.[35] In contrast,

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30. Zaremba v. National Union Fire Ins. Co., 1979 Fire & Casualty Cas. (CCH) 1302, 1304 (N.D. Ohio 1979).

31. *Id.* at 1306.

32. "It is agreed with respect to [the] question [of prior knowledge] that if such knowledge or information exists, any claim or action arising therefrom is excluded from this proposed coverage." *See, e.g.*, F/H Indus., Inc. v. National Union Fire Ins. Co., 635 F. Supp. 60 (N.D. Ill. 1986); Shapiro v. American Home Assurance Co., 584 F. Supp. 1245 (D. Mass. 1984).

33. *National Union Fire Ins. Co.*, 643 F. Supp. at 1439-41.

34. *F/H Indus., Inc.*, 635 F. Supp. at 64.

35. *Id.*

estoppel precludes an insurer from asserting a coverage position where, because of its conduct, it would be inequitable not to do so and its insured thereby suffered prejudice.[36]

A recent California decision involved an action by Federal Insurance Company to rescind its policy because of material misrepresentations by the insured in public filings and statements.[37] The action was not based upon the application but upon statutory Insurance Code provisions permitting rescission where the insured concealed or misrepresented a material fact.[38] The case dealt with an omission, a failure to make a voluntary disclosure. Although the court initially observed that the insurer had not inquired as to the insured's knowledge pertaining to the facts allegedly omitted, it rested its denial of relief upon the insurer's delay in seeking rescission or reformation. The court found that the insurer's fifteen month delay in asserting its intent to cancel a policy gave rise to an estoppel, thus precluding the equitable remedy of rescission.[39]

Where the issue concerned an affirmative misrepresentation in the application, however, a recent decision of the Northern District of California found, as a matter of law, that the defenses of waiver and estoppel were not valid.[40] The court permitted rescission for the insurer which had waited only three months to rescind after having received the information upon which it sought relief. The only prejudice to the insured was the delay in return of $30,000 of premiums, which, the court stated, "hardly constitutes substantial prejudice."[41] Moreover, the delay was partly attributable to the refusal of the insured to accept the money.[42]

C. *Policy Limits*

Two limits are specified: (1) a per claim or occurrence limit, and (2) an annual aggregate for all claims. The "per claim" limit may be expressed as an "occurrence" limit, usually meaning that the company will pay no more than that sum for all claims arising

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36. *Id.* (no showing of prejudice).

37. Federal Ins. Co. v. Oak Indus., Inc., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,519, at 93,118 (S.D. Cal. Feb. 3, 1986).

38. CAL. INS. CODE §§ 331, 359.

39. *Federal Ins. Co.*, Fed. Sec. L. Rep. (CCH) ¶ 92,519, at 93,120.

40. Jaunich v. National Union Fire Ins. Co., 647 F. Supp. 209 (N.D. Cal. 1986).

41. *Id.* at 216.

42. *Id.*

out of the same wrongful conduct regardless of the number of claimants. The aggregate limit is usually defined as the total limits available for all claims made within the policy year.

D&O policies typically indemnify against "loss" up to the applicable limit of liability stated on the face sheet of the policy. Issues often arise concerning whether the "per claim" or "aggregate" limits of liability apply. The causation analysis inquires whether there was one continuing and uninterrupted cause of the damages.[43] For example, a 1985 Kansas federal decision concerned a series of improper loans which resulted in a receivership by the Federal Savings and Loan Insurance Corporation (FSLIC) and a lawsuit to determine the available limits of a North River policy which had a per occurrence limit of $1 million.[44] The insurer's prior policy was on a per "incident" basis, which the court found virtually synonymous with the more typical per "occurrence" language.[45] In any event, the court concluded that the various loan swaps were separate since each was at a separate time for different borrowers, for different purposes and with separate collateral. Moreover, the court stated that the cause of the various losses was not the loan swap program but the unprofitable approval of each loan. Each loan therefore constituted a separately insured occurrence, each having a $1 million limit available.[46]

D. *Indemnity or Liability?*

Directors' and officers' coverage can be written on an "indemnity" or a "liability" basis. The so-called "legal liability" policy form provides for protection regardless of whether the insured has been required to pay the claimant and includes a duty by the insurer to defend. In contrast, the "indemnification" policy provides only that the company will indemnify the insured and the company assumes no obligation to do so until the insured has paid a loss from which the coverage is afforded. Although an indemnity policy does not normally provide payment for defense costs, as does a liability policy,[47] some jurisdictions, such as California, statutorily imply such coverage unless a contrary intent appears in the policy.[48]

43. *See* North River Ins. Co. v. Huff, 628 F. Supp. 1129 (D. Kan. 1985).
44. *Id.*
45. *Id.* at 1133.
46. *Id.*
47. *See* MALLEN & LEVIT, *supra* note 21, § 705 (The Policy—The Insuring Agreement—Liability or Indemnification).
48. *See* Employers Reinsurance v. Mission Equities Corp., 74 Cal. App. 3d 826, 141 Cal. Rptr. 727 (1977).

Insurers had assumed that the typical D&O contract was an indemnity form and therefore did not require interim payments of attorneys' fees and costs.[49] However, the Ninth Circuit Court of Appeals recently promulgated a very significant decision affecting D&O coverage. In *Okada v. MGIC Indemnity Corp.*,[50] each of the insured directors had hired counsel to defend various shareholder direct and derivative claims, and sought reimbursement for defense costs as incurred. Applying the usual rules of strict construction, the court concluded that the traditional directors' and officers' form was a "duty to defend" policy. The court stated that the basic insuring agreement required the company to pay "all loss which the Directors and Officers or any of them shall become legally obligated to pay."[51] The definition of "loss" referred to sums either which the directors and officers were obligated to pay or for which the association was obligated to indemnify.[52] Therefore, the policy included defense of legal actions.

The court found that Clause 5, pertaining to costs, charges and expenses, provided a duty to defend. The court specifically relied on Clause 5(a): "No costs, charges and expenses shall be incurred or settlements made without the Insurer's consent, which consent shall not be unreasonably withheld; however, in the event such consent is given, the Insurer shall pay, subject to the provisions of Clause 4, such costs, settlements, charges and expenses."[53] The

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49. *See* Bisceglia, *Practical Aspects of Directors' and Officers' Liability Insurance—Allocating and Advancing Legal Fees and the Duty to Defend*, 32 U.C.L.A. L. REV. 690 (1985); W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 20.16 (3d ed. 1978).

50. 795 F.2d 1450 (9th Cir. 1986).

51. *Id.* at 1452.

52. *Id.* The court set forth the relevant definitional provisions of the MGIC policy, including the definition of "Loss":

> (d) The term "Loss" shall mean any amount which the Directors and Officers are legally obligated to pay or for which the Association is required to indemnify the Directors or Officers, or for which the Association has, to the extent permitted by law, indemnified the Directors and Officers for a claim or claims made against the Directors and Officers, for Wrongful Acts, and shall include but not be limited to damages judgments, settlements, costs (exclusive of salaries of officers or employees), and defense of legal actions, claims or proceedings and appeals therefrom and cost of attachment or similar bonds; provided, however, such Loss shall not include fines or penalties imposed by law or matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed.

Id.

53. *Id.*

insurer argued that this gave it the option but not the *duty* to pay, pointing to Clause 5(c):

> The Insurer may at its option and upon request, advance on behalf of the Directors or Officers, or any of them, expenses which they have incurred in connection with claims made against them, prior to disposition of such claims, provided always that in the event it is finally established that the Insurer has no liability hereunder, such Directors and Officers agree to repay to the Insurer, upon demand, all monies advanced by virtue of this provision.[54]

Citing but not defining the so-called "reasonable expectations" test, the court found a duty to defend.[55] Clause 5(c) was found ambiguous because it specifically did not state "which types of claims it intended to cover." Without explanation, the court characterized Clause 5(c) as a reservation of rights clause. In reaching its conclusion, not only did the court fail to specify why there was a "reasonable expectation" of coverage, but it also ignored the near-unanimous construction which the industry itself and its insureds had given the clause, namely, not imposing a duty to defend.[56]

Although for these reasons the logic of *Okada* may be criticized and debated, it has already established a precedent which was followed by the Second Circuit, which construed a similar D&O policy in the same manner.[57] Since many directors' and officers' policies are similar, the impact of the *Okada* decision will be immediate and widespread unless and until the insurers rewrite the forms to achieve what they thought was already an indemnity format. Ironically, although such decisions impose the burdens of a "liability" policy, none of the benefits exist. Since the policies were perceived to be indemnity forms, the insurers did not assert the traditional rights to select defense counsel or control or even participate in the defense decisions. The duty to defend, however, is not unlimited since those costs are subtracted from the policy limits.[58]

Subsequent to the *Okada* decision, the Ninth Circuit provided another innovative interpretation of the D&O form in *MGIC Indemnity*

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54. *Id.*

55. *Id.* at 1454.

56. *Id.*

57. *See* Pepsico, Inc. v. Continental Casualty Co., 640 F. Supp. 656 (S.D.N.Y. 1986).

58. *See supra* note 17 and accompanying text.

Corp. v. Weisman,[59] an action by an insurer for alleged fiduciary breaches and RICO violations by counsel for an insured director. The theory of the lawsuit was that the attorneys instigated the lawsuit by shareholders and then undertook to defend director-shareholders at the insurer's expense but without disclosing the conflict. The court agreed with the insurer that the insured's independent counsel, although selected without the insurer's consent, still owed fiduciary obligations to the company:

> [I]t is an untenable simplification to say that they had no duty to the company they knew would pay the legal fees of the directors. A lawyer may have more than a single client in a lawsuit. A "client" is the person or entity on whose behalf a lawyer acts. Weisman and Dunn were acting for the insurer as well as for the insured. . . .
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> Their function defines their responsibility. They owed a duty of loyalty to the insurer as well as to the insured. That duty of loyalty included a duty of candor. . . . Anyone paying legal bills would want to know, and would be entitled to know, that the lawyers being paid were the very lawyers who started the suits they were now being compensated to defend. The alleged failure to disclose their activity was a breach of the fiduciary duty Weisman and Dunn owed MGIC.[60]

Since the insurer, however, knew of the attorneys' double role, it could not complain of their nondisclosure.

Until *Weisman*, the general industry assumption had been that the principal leverage a D&O insurer had over the conduct of an insured's counsel was the cooperation clause of the policy and the insurer's obligation to pay only reasonable expenses. No other court in a case involving independent counsel had suggested a direct fiduciary duty to the *insurer*. The Ninth Circuit's imposition of a fiduciary relationship with the insurer should logically include an obligation upon the insured's chosen counsel to report and candidly advise about the insured's liability and damage exposure.

E. *Insuring Agreement*

The basic coverage afforded appears in the Insuring Clause or

59. 803 F.2d 500 (9th Cir. 1986).
60. *Id.* at 504.

Agreement and runs to the directors and officers. The common insuring language is that the insurer will pay on behalf of the directors and officers loss arising by reason of any wrongful act done, attempted or allegedly done by the directors and officers. The definition of "loss" usually expressly excludes fines or penalties.[61] Whether a "claim" includes the cost of legal representation in connection with grand jury proceedings, criminal investigations or regulatory probes has become a matter of concern to many corporate officials. Some policies include in the definition of "loss" the costs of defending "legal actions, claims or *proceedings*."[62] In pending litigation, some insureds have argued that the foregoing language obligates the insurer to pay for legal representation in connection with such matters. Although no court has expressly ruled on this point, a federal district court in New York, in upholding a corporation's claim for reimbursement of the costs of defending securities fraud claims, implied that coverage might exist for the cost of defending criminal proceedings.[63]

The "wrongful act" definition pertains to an error while acting in the *capacity* as an officer or director, or by virtue of the *status* of being an officer or director.[64] Coverage for the company may also be included or available in a separate section for Company Reimbursement.[65] When coverage for the company is present, it provides for payment arising from such vicarious liability but is subject to the qualification that the company would otherwise be required or permitted to indemnify the directors and officers for the loss.[66] As a matter of practice, most of the claims are treated under the company reimbursement portion.

The policy form may be upon an occurrence basis, affording protection if the wrongful act occurred during the policy year. Modern policies, however, are on a claims-made basis, requiring that the claim be made against the directors and officers during the policy

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61. *See supra* note 52 and accompanying text.

62. *Id.*

63. *See Pepsico*, 640 F. Supp. at 660 (corporation's costs of defending directors and officers in connection with federal securities fraud claims properly subject to reimbursement by insurer where corporation enacted bylaw permitting indemnification of directors and officers for such costs). *See also* DEL. CODE ANN. tit. 8, § 145(a) (1983).

64. *See supra* note 17 and accompanying text.

65. *Id.*

66. *Id.*

year. A recent requirement included in some present forms is that the claim also be reported to the insurer during the policy year.

The policy is usually written to include a loss deductible or retention, the amount of which may vary from insurer to insurer and also may vary with the insured. The retention typically applies to each insured up to a specified maximum aggregate, such as $10,000 per insured subject to a $30,000 aggregate. Coinsurance provisions are routine and require the directors and officers or the company to pay a percentage of the loss, usually five percent.

The definition of insureds expressly includes the officers and directors.[67] The named insureds are those expressly identified within the policy face sheet. The other insureds ("additional" insureds) are those who qualify by virtue of coming within the policy definitions of specified status or relationship.[68] Insureds may be added by endorsement, usually for an additional premium.

F. *Exclusions*

Exclusions are provisions which detract from or eliminate coverage otherwise present in the policy. Because of the detraction from coverage, the courts have adopted a rule of strict construction to limit the effect of exclusions.[69]

In liability forms, the principle and most common exclusion pertains to so-called "willful acts" or "fraud."[70] In the D&O policy, the exclusion focuses upon "dishonesty." Such an exclusion was the subject of a 1978 Fifth Circuit decision.[71] The case involved a dispute between a banker's blanket bond insurer and a D&O insurer as to which of them should pay the loss resulting from a former president's issuance of several letters of credit without authorization and with strong evidence of dishonesty. The exclusion was noted to have been adopted verbatim from section 727 of the 1970 New Business Cor-

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67. *Id.*

68. For example, the Lydando No. 1 form includes directors and officers in three categories: (1) of the parent company, (2) of the subsidiaries existing at the inception date of the policy, and (3) of subsidiaries created or acquired during the policy period subject to notice being given to the insurer. Other policies have different definitions. *See supra* note 17 and accompanying text.

69. *See, e.g.*, KDT Indus., Inc. v. Home Ins. Co., 603 F. Supp. 861 (D. Mass. 1985).

70. *See* MALLEN & LEVIT, *supra* note 21, § 718 (General Rules and the "Fraud" Exclusion).

71. Elgin Nat'l Bank v. Home Indemnity Co., 583 F.2d 1281 (5th Cir. 1978).

porations Law. The court explained that the predicates of an employee's acts being "dishonest and fraudulent" were willfulness and an intent to deceive, thereby falling within the language in the bond.[72] Summary judgment was affirmed in favor of the D&O insurer because the conduct covered by the banker's blanket bond would necessarily be excluded under the D&O insurer's coverage.[73]

A common limitation on that exclusion, as used in the Lydando No. 1 form, appears as an "exception": "Unless a judgment or other final adjudication thereof adverse to the Directors or Officers shall establish that acts of active and deliberate dishonesty committed by the Directors or Officers with actual dishonest purpose and intent were material to the cause of action so adjudicated."[74]

The significance of the exception was the subject of a 1986 New York district court decision concerning a D&O insurer's obligation to indemnify a settlement made on a claim for violations of section 10(b) of the Securities Exchange Act of 1934[75] and for defense costs incurred up to the time of settlement.[76] The court focused on the exclusion's requirement that there be a "final judgment or other final adjudication," finding that the settlement compromise precluded the operation of the exclusion.[77] Although the SEC investigation resulted in charges against the corporation, none were asserted against the directors and officers. The court distinguished a prior decision involving stockbrokers[78] because the policy involved had no such requirement that there be a final judgment or adjudication.[79] Moreover, observed the court, there was no public policy or contractual exclusion barring reimbursement of settlement or defense costs. The corporation had also adopted a bylaw, in accord with applicable law, that broadened its ability to indemnify its directors and officers.[80]

Another exception purports to provide coverage for "innocent insureds." That exception, although previously common, is now being written out of many professional liability policies. The reason

72. *Id.* at 1287.
73. *Id.* at 1288.
74. *Pepsico*, 640 F. Supp. at 659. *See also supra* note 17 and accompanying text.
75. 15 U.S.C. § 78j(b) (1982).
76. *Pepsico*, 640 F. Supp. at 656.
77. *Id.* at 659.
78. Stargatt v. Avenall, 434 F. Supp. 234 (D. Del. 1977).
79. *Pepsico*, 640 F. Supp. at 660.
80. *Id.* at 660-61.

is simply that the wrongful acts exclusion is ineffective if the insurer simply ends up paying the same loss on behalf of another insured who is vicariously liable or is sued for negligent supervision for the conduct of the wrongdoer.

A further and important exclusion is to avoid indemnifying officers and directors for any personal profit or gain which they may be liable to repay. In conjunction with that provision, an exception may exist for innocent insureds. Such a provision could provide: Any fact pertaining to any one Director or Officer shall not be imputed to any other Director or Officer for the purpose of determining the application of the exclusions.

Other exclusions are less common and reflect concerns of particular underwriters. For example, litigation is a common consequence of takeover actions, much of it resulting from claims by unhappy minority shareholders. The Home Insurance Company drafted an exclusion to address those concerns:

> [T]he Insurers shall not be liable to make payment for loss in connection [sic] Officers/Insureds directly or indirectly arising from any attempt to gain control or from any gaining of control of the Company or any Claim made by any minority stockholder of the Company.
>
> It is further agreed that in the event that control of the Company is acquired by any corporation, person or group of persons by merger, consolidation, acquisition of stock or assets or otherwise, this policy shall exclude any claim made by or in the right of any such corporation, person or group of persons.[81]

The exclusion, however, was construed not to apply to a minority shareholder's suit complaining about the "unfairness" of an acquisition agreed to by majority shareholders. Strictly construing the exclusion, the court held that the claim concerned the fairness of the transaction, not the fact of the takeover.[82]

A variety of exclusions concern claims made by "an Insured . . . except for stockholder derivative actions brought by a shareholder of the Company other than as an insured."[83] The issue in a recent

81. *KDT Indus., Inc.*, 603 F. Supp. at 862.

82. *Id.* at 869.

83. Federal Deposit Ins. Corp. v. National Union Fire Ins. Co., 630 F. Supp. 1149 (W.D. La. 1986).

Louisiana federal decision was whether this coverage limitation precluded a claim by the Federal Deposit Insurance Corporation (FDIC) as receiver to a failed bank.[84] In holding the limitation inapplicable to the FDIC as successor to the insured, the court stated that the FDIC should only be barred by an exclusion expressly applicable to it since it acted on behalf of both the insured and the shareholders as if in a derivative action.[85]

Many insurers today are concerned about having to pay pollution or environmental losses under a D&O policy. Since no one has yet ascertained the "magic words" to preclude coverage, the verbiage of such exclusions is in transition. Other exclusions may pertain to ERISA liability; attempts are also being made not to insure employment discrimination or wrongful termination claims.

G. *Allocation of Costs*

The allocation of defense costs, settlements or judgments is a recurring issue for insurers of directors' and officers' liability. The issue can arise because of the presence of noncovered theories of liability, damages or persons. The policy may provide a basis for allocation:

> In any claim against both Directors and Officers and any other party or parties, costs, charges and expenses for investigation or defense shall be limited to those incurred in the right of and for the principal benefit of the Directors and Officers, as distinguished from any such other party or parties, and Underwriters and the Directors and the Officers shall endeavor to establish at the earliest opportunity a proper basis for the allocation of the costs, charges or other expenses of counsel or others rendering services to or for the benefit of both the Directors and Officers and such other party or parties.[86]

Even without such a provision, allocation may proceed on common law principles. The issue was examined in *Pepsico, Inc. v. Continental Casualty Co.*,[87] where a settlement of the liability suit

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84. *Id.* at 1152.
85. *Id.* at 1157.
86. *See* Hinsey, *New Policy Form*, *supra* note 17, app. A, § 6(c).
87. 640 F. Supp. 656 (S.D.N.Y. 1986).

included not only the directors and officers but also the corporation's accountants. The policy provided for payment to the corporation only for the amount it indemnified the directors and officers. Although New York law permitted apportionment of a settlement on the basis of who was insured, the court stated that the burden of proof rested upon the insurer. The court suggested an approach similar to that used in allocating contribution among joint tortfeasors requiring proof of relative fault.[88]

A 1985 Maryland decision upheld apportionment of legal expense between covered and noncovered counts.[89] The standard to be used was whether the expenses were "reasonably related" to the covered claims. Thus, the expense of defending a noncovered theory would not require apportionment if the same services were required for the covered theory. In contrast to the New York *Pepsico* decision, the burden was upon the insured to establish which services and expenses were reasonably related to the covered counts, and failing to do so the insured could only recover "nominal" damages.[90]

H. *Discovery Clause*

Claims-made policies typically provide that an insured may report facts or circumstances which are perceived as likely to give rise to a claim and that the company will treat the claim as having been made within the policy period regardless of when it is made. This seemingly generous extension of coverage actually provides protection made essential by a limitation in a subsequent insurer's policy precluding coverage for circumstances which should be known as likely to give rise to a claim, as of the inception date of such policy.

The discovery clause is particularly important if the company changes insurers, and is essential if the corporation cannot obtain new coverage. In reporting potential claims to a present insurer, it is important to remember that such circumstances will have to be disclosed to a future insurer. The failure to make a disclosure can be a basis for rescission. Reporting a laundry list of potential claims upon a present insurer can create the impression of an undesirable risk for a future insurer which will inquire in its application about

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88. *Id.* at 663.

89. Continental Casualty Co. v. Board of Educ. of Charles County, 302 Md. 516, 489 A.2d 536 (1985).

90. *Id.* at 536, 489 A.2d at 546.

prior claims. The explanation that the company was simply taking advantage of the prior insurer will not enhance perceptions of fair treatment for a future insurer. In fact, the opposite is probably true. Thus, a rule of reason is called for. Laundry lists are inappropriate (except where there is no new insurer) and only those circumstances which are perceived as presenting a realistic risk of a future claim should be disclosed.

Moreover, the discovery clause may further provide for an extended reporting endorsement, also known as "tail" coverage. This enables an insured to report to the company for a specific period of time claims arising out of wrongful acts committed before the policy expired.[91]

III. ALTERNATIVES TO D&O INSURANCE

A. *Introduction*

As directors' and officers' liability insurance became increasingly scarce or prohibitively expensive, many corporations discovered they were losing or were unable to recruit qualified, independent directors for their boards. For many persons the risk of personal liability without the prospect of indemnification can outweigh the prestige and minimum compensation of being a director. Thus, many companies have considered alternatives to D&O insurance in order to preserve the benefits of corporate governance by independent directors. Such alternatives range from self-insurance and creation of insurance "captives" to indemnification agreements. A more recent response has been legislation authorizing companies, with stockholder approval, to limit the liability of their directors for certain types of negligent conduct. These alternatives are examined in the following sections of this article.

B. *Statutory Limitations on Directors' Liability*

In June 1986, in direct response to the perceived "crisis" in the availability and scope of D&O liability insurance, the Delaware legislature adopted section 102(b)(7) of the Delaware General Corporation Law.[92] The legislation apparently represents an effort to

91. The Lydando No. 1 form provides that option if the company cancels or refuses to renew. The option is typically valid for 90 days and for an additional premium.

92. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986). Section 102(b)(7) was signed into law on June 18, 1986 and became effective July 1, 1986.

return directors and Delaware corporations to the position that they occupied prior to the perceived crisis in D&O insurance. Another goal implicit in the content of the statute is to ensure that the present system of corporate governance by independent boards of directors should remain viable.[93]

Section 102(b)(7) provides that a corporation, in its original certificate of incorporation or by amendment approved by its stockholders, may adopt:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under Section 174 of this Title, or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this subsection to a director shall also be deemed to refer to a member of the governing body of the corporation which is not authorized to issue capital stock.[94]

Section 102(b)(7) enables a corporation, in its original certificate of incorporation or by an amendment approved by stockholders, to eliminate or limit the personal liability of directors for violations of the directors' fiduciary duties of care. However, the amendment does not purport to affect directors' liability for breach of their duty of loyalty, the failure to act in good faith, intentional misconduct, knowing violations of law, paying a dividend or approving a stock repurchase for which funds were not available, or obtaining any improper personal benefit.

There are four important limitations which also reflect the ap-

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93. *See* Veasey & Finkelstein, *New Delaware Statute Allows Limits on Director Liability and Modernizes Indemnification Protection*, 6 BUS. LAW. UPDATE 1-3 (1986). *See also* Balotti & Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5 (1987).

94. DEL. CODE ANN. tit. 8, § 102(b)(7).

parent purpose of the framers of the amendment to return directors and Delaware corporations to the position they occupied before the recent erosion of the D&O liability insurance market. First, section 102(b)(7) requires that an existing corporation obtain approval of its stockholders to amend its certificate of incorporation to include the amendment. By leaving this decision in the hands of the owners of a corporation, the legislature apparently sought to enhance the opportunity for such corporations to attract and preserve competent, qualified and independent directors who might otherwise be reluctant to serve in the absence of adequate D&O insurance.[95]

Second, corporate officers are not included within the ambit of the amendment. The primary purpose of the amendment appears to have been to preserve and enhance the prospect of independent outside directors serving on boards of Delaware corporations.[96] Officers were apparently not perceived to be likely to depart in the absence of D&O insurance.

Third, the various statutory limitations in the amendment on those breaches of fiduciary duty against which a director may be protected generally coincide with the typical exclusions available in most D&O insurance policies. For example, typical D&O insurance policies exclude claims based upon the obtaining of personal profit, dishonest or bad faith conduct or claims based upon allegations the directors acted with knowledge or reasonable cause to believe that their actions were in violation of law.[97] These limitations continue in force under the amendment. Again, the intent of the legislature appears to have been to return directors to the same posture they occupied prior to the D&O insurance crisis.

Finally, equitable remedies against breaches of duty by a director, or to rescind actions by a board, such as injunctive or declaratory relief, are expressly preserved under the amendment. Thus, the new Delaware statute was designed to eliminate only one remedy for breach of a director's fiduciary duty, and then only if such a limitation is approved by a majority of the owners of the corporation.

Some will no doubt criticize the amendment for detracting from the standard of care now imposed upon corporate directors because

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95. *See Pepsico*, 640 F. Supp. 656 (S.D.N.Y. 1986).

96. *Id.*

97. Block, Barton & Radin, *Indemnification and Insurance of Corporate Officials*, 13 SEC. REG. L.J. 239, 251 n.46 (1985) [hereinafter Block, Barton & Radin].

of the statutory protection from liability for improper and/or negligent conduct. Some may argue that the absence of any co-insurance provisions, such as an insurance policy deductible, has created a "windfall" for directors who no longer face personal responsibility for the first portions of any loss.[98]

Although the amendment is intended to restore a sense of security to those corporations and boards that have faced the prospect of no insurance, and the resultant departures of outside, independent directors,[99] its protection, however, may be somewhat illusory. The statutory protection applies only to ultimate liability, and not to defense. For the antagonist, a liability claim may be postulated not by varying facts but simply by the characterization of the legal theory or nature of the wrong. In other words, conduct which in the past has been characterized as a breach of the fiduciary duty of care might now be characterized by plaintiffs as a breach of the duty of loyalty, hence sidestepping the intended effect of the amendment. Since the statute should have only minimal effect in reducing the number of lawsuits, the immense exposure for defense costs still exists.

On one hand, the statute may make insurance more available because it eliminates the exposure to *indemnify* those enumerated risks. On the other hand, an insurer's defense costs may actually be increased by the statute. The statute tends to eliminate previously covered exposures, such as negligence liability, requiring the claimants to pursue theories which are typically not insured. Thus, in an effort to avoid uninsured exposures, insured directors are likely to insist upon a very complete, and therefore more expensive, defense.

C. *Response of Other States*

In contrast to the response of the Delaware Legislature, Utah rejected the opportunity to limit the liability of corporate officers and directors. The Utah State Senate initially passed Senate Bill No. 214 and sent it to the Governor in March 1986.[100] While portions of

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98. Many D&O insurance policies typically provide deductibles of $5,000 to $10,000 per claim for each director sued.

99. Many companies have already sought and obtained shareholder approval to eliminate directors' liability for negligence pursuant to § 102(b)(7). *See* Crossen, *Companies Ask Holders to Limit Boards' Liability*, Wall St. J., Oct. 7, 1986, at 37, col. 3.

100. *Corporations and Assumed Name Amendments*, 1986 General Session, Utah Senate Bill No. 214.

that bill were quite similar to the Delaware statute, the Utah bill also proposed to limit the liability of officers and trustees of corporations, as well as directors. Like the Delaware statute, the Utah bill exempted losses which resulted from fraud, bad faith, or which were based on conduct which did not promote any rational or legal business purpose of the corporation.[101]

The bill engendered a storm of controversy and was opposed by the Bar Commissioners of the Utah State Bar and the United States Attorney for the District of Utah.[102] The significant limitations on the potential liability of corporate directors and officers was cited as the principal reason for these objections. Citing these concerns, on March 18, 1986, Utah Governor Norman H. Bangerter vetoed S.B. No. 214.[103]

Indiana and Virginia enacted legislation similar to the Delaware statute in the months preceding the adoption of section 102(b)(7).[104] Missouri recently enacted a comprehensive bill designed to provide greater specificity regarding the circumstances under which officers and directors may be indemnified by the corporation.[105] Such provisions are quite similar to the Delaware indemnification statute.[106] The amendment also contained a provision analogous to the Delaware statute limiting the liability of corporate directors,[107] with several important distinctions. The bill empowers Missouri corporations to provide "any further indemnity" they choose to officers, directors, employees and others, provided such "further indemnity" is authorized in the corporation's articles of incorporation or in a bylaw adopted by a vote of shareholders.[108] Indemnification is prohibited in the event the prospective indemnitee's conduct is adjudged to have been "knowingly fraudulent, deliberately dishonest or willful."[109] Significantly, and in contrast to the Delaware statute, officers

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101. *Id.* § 16-10-44.5(4)(a).

102. Letter from United States Attorney Bret P. Ward to Governor Norman H. Bangerter (Mar. 18, 1986); Letter from Norman S. Johnson, President, Utah State Bar, to Stephen F. Mecham, Assistant to Governor Bangerter (Mar. 18, 1986) (available in Utah Office of Legislative Research).

103. Letter from Governor Norman H. Bangerter to Arnold Christensen, President, Utah State Senate (Mar. 18, 1986) (available in Utah Office of Legislative Research).

104. *See* IND. CODE § 23-1-37-9 (1986); VA. CODE ANN. § 13.1-690 (1985).

105. MO. REV. STAT. § 351.355(7) (1986).

106. *See* DEL. CODE ANN. tit. 8, § 145 (1983).

107. *Id.* § 102(b)(7).

108. MO. REV. STAT. § 351.355(7) (1986).

109. *Id.*

and employees may receive such indemnity.[110] The language of the statute is probably broad enough to enable a corporation to enact provisions limiting the civil liability of its officers and directors so long as such a limitation could be construed as a "further indemnity" for purposes of the new statute.

D. *Indemnification Contracts*

One of the greatest threats posed by the lack of D&O insurance is the risk that attorneys' fees and other litigation expenses might have to be borne by directors and officers themselves. In order to attract and retain competent officers and independent outsiders to their boards, many corporations have entered into agreements to indemnify their directors and officers for such expenses.

Section 145 of the Delaware General Corporation Law empowers corporations to indemnify officers, directors, employees and agents, as well as persons serving in such capacities for other entities at the request of the corporation. Indemnification provisions have also been enacted in most other states.[111] However, they differ widely in scope and application. This article focuses on the Delaware statute, which has been the exemplar for substance and format in more than twenty states.[112]

Section 145 distinguishes between two types of suits: those brought by a corporation or by its stockholders in the right of the corporation (so-called "stockholder derivative suits"), and all other actions, suits or proceedings, whether civil, criminal, administrative or investigative, often referred to as "third-party" actions.

Expenses, including attorneys' fees and the amounts of any judgments, fines or settlements, may be the subject of an indemnity agreement between a director and the corporation with respect to third-party actions.[113] To determine whether indemnification is proper the test is whether the director "acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation."[114] This inquiry appears to have been based upon the duty of loyalty owed by directors to the corporation.

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110. *Id.*
111. Block, Barton & Radin, *supra* note 97, at 241 n.5.
112. *Id.*
113. DEL. CODE ANN. tit. 8, § 145(a) (1983).
114. *Id.*

In actions brought by or on behalf of the corporation, such as stockholder derivative suits, the corporation is permitted to indemnify a director, officer or employee only against "expenses (including attorneys' fees) actually and reasonably incurred by him in connection with the defense or settlement of such action or suit."[115] Some commentators have suggested that the omission of "judgments, fines and amounts paid in settlement" was intentional with respect to derivative actions.[116] The person to be indemnified must also have "acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation."[117] In criminal actions, the party seeking indemnity must have "had no reasonable cause to believe his conduct was unlawful" in order to be reimbursed.[118]

Section 145(c) mandates indemnification where the section 145(c) person to be indemnified has been "successful on the merits person or otherwise."[119] The statute also mandates partial indemnification in the event of partial success.[120]

Section 145(b) prohibits indemnification where the person to be indemnified has been found liable for negligence or misconduct in the performance of his duty, unless the Delaware Court of Chancery determines that the person is entitled to indemnity. In Delaware, an indemnification contract broader than the statutory scheme of section 145 must be based upon an "independent legal ground."[121] Although what constitutes an "independent legal ground" may be susceptible of varying interpretations, some form of consideration, stockholder approval or demonstrable benefit to the corporation would probably have to be shown.

One of the more significant aspects of the indemnification provisions of the Delaware statute is the opportunity for directors and officers to obtain advance payments of litigation expenses prior to the final disposition of the action.[122] One court considering this issue

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115. *Id.* § 145(b).

116. *See* Block, Barton & Radin, *supra* note 97, at 244 n.20. *But see* DEL. CODE ANN. tit. 8, §§ 145(a), (b).

117. DEL. CODE ANN. tit. 8, § 145(b).

118. *Id.* § 145(a).

119. *Id.* § 145(c).

120. *Id. See also, e.g.*, Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138 (Del. 1974) (*Wolfson II*).

121. *See* Mooney v. Willys-Overland Motors, Inc., 204 F.2d 888, 896 (3d Cir. 1953) (construing Delaware law).

122. DEL. CODE ANN. tit. 8, § 145(e) (Supp. 1986).

required a D&O carrier to make such advances for litigation expenses notwithstanding that the policy in question purported to provide indemnification only for loss rather than for threatened liability, and contained no language providing an express duty to defend.[123]

In order to obtain such an advancement, a director or officer must give an "undertaking" to the corporation under which he or she would become obligated to reimburse the corporation for any advances should it be determined that the indemnification is not permitted. Such an undertaking may be merely some form of promise or personal guarantee; security is not essential.[124]

The failing of any indemnification agreement is that even if such an agreement is valid, its significance depends upon the financial stability of the corporation. For the established, financially solid corporation indemnification agreements afford meaningful and reliable protection for directors and officers. For the newly formed or thinly capitalized company, the protection of the indemnity agreement may be illusory. Many lawsuits against directors and officers are brought because the financial failure of the corporation leaves them as the only potentially deep pockets. Attempts to fund indemnity agreements with letters of credit tied to established escrow accounts generally are not economically feasible for those corporations whose financial instability pose the risk of future litigation. Thus, for such corporations, indemnity agreements may not be a meaningful substitute for D&O liability insurance.

E. *"Captive" or Subsidiary Insurance Companies*

Many corporations have considered, and some have formed, wholly owned D&O insurance subsidiaries, often referred to as "captive" insurers. Recently, a rash of captive or mutual companies have been formed to insure, reinsure or provide excess limits for D&O risks.[125] The financial stability of these entities remains unproven.

There are, however, numerous considerations pertaining to pursuing the "captive" route. Such entities will undoubtedly be carefully scrutinized to determine whether and to what extent it is truly independent of the parent corporation. Inquiries which may be rel-

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123. *See* Okada v. MGIC Indemnity Corp., 795 F.2d 1450 (9th Cir. 1986). *See also* Bisceglia, *Practical Aspects of Directors' and Officers' Liability Insurance—Allocating and Advancing Legal Fees and the Duty to Defend*, 32 U.C.L.A. L. REV. 690 (1985).

124. Block, Barton & Radin, *supra* note 97, at 247 n.34.

125. *See, e.g.*, Taravella, *Alternative Facilities*, *supra* note 8, at 26.

evant to this issue include whether the subject insurance policy delineates the scope of the captive insurer's liability and expressly defines the circumstances which give rise to coverage; whether the insurer is adequately capitalized and qualified to do business under the particular state's insurance laws; the method by which premiums are calculated; and who will ultimately control the determination of whether particular claims are covered, the parent corporation or an independent representative of the insurer.

To the extent it appears that the captive is deemed to be entirely a creature of the corporation, controlled by and dependent upon it for its existence, such an entity may not be considered sufficiently independent to preserve a separate corporate existence. Nevertheless, assuming the various issues outlined above are satisfactorily resolved, the formation of a captive or subsidiary insurance company may well provide relief for corporations which are otherwise unable to obtain sufficient D&O or other liability insurance.

The effectiveness of a captive depends upon both capitalization and risk sharing. Pooling by many corporations enables a more meaningful apportionment of risk. Obtaining reinsurance on a pro rata or excess basis can provide even more meaningful protection. The future of the captive insurer, however, has to be reconsidered in light of the totally revised Internal Revenue Code of 1986. In fact, a little noticed provision inserted in the new tax bill during the House-Senate Conference Committee's deliberations will make captive insurers domilciled in Bermuda much more costly to their investors.[126] Especially hard hit are those law firms belonging to the Bermuda-based Attorneys' Liability Assurance Society (ALAS), the largest captive insurer of law firms with forty or more attorneys in the United States.[127]

The new provision requires that any U.S. citizen owning an interest in a Bermuda Corporation must now pay tax on the corporation's income regardless of the extent of ownership, and regardless whether such profits are actually distributed to shareholders. Formerly, only owners of more than ten percent of an offshore captive's stock faced such taxes; smaller investors could defer tax until profits were actually distributed. Coincidentally, another recent

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126. *See* 26 U.S.C.A. § 832 (1986). *See also* Pub. L. No. 99-514, 100 Stat. 2085 (1986).

127. *See* Eisler, *Lawyer's Insurer May be Doomed*, Legal Times, Nov. 3, 1986, at 1, col. 4.

federal statute, the Liability Risk Retention Act of 1986,[128] may spur the growth of domestically chartered group-owned captive insurance companies.[129]

F. *Self-Insurance*

In the absence of adequate D&O insurance, many companies are forced to self-insure. The term "self-insurance" is really misleading. A corporation which self-insures is really *uninsured* whether it does so through choice or fortune. A common form of risk retention involves increasing D&O deductibles which in recent years have expanded into the six-figure range. Of course, this may be only a last resort for many corporations. Nevertheless, many companies have discovered that self-insurance can be a more cost-effective means of a compromised protection, especially in a time of extremely high premiums. The risk may be oppressive but bearable and the higher level coverage can enable financial survival. Generally a company should evaluate all sides of the economic equation before self-insuring, including the prospect of bearing the not inconsiderable costs of litigation and the ultimate exposure of an adverse judgment.

IV. LOSS PREVENTION

A. *Loss Prevention in the Boardroom*

The phrase "loss prevention," although common in the industrial sector and health care field, has gained increasing recognition for a variety of professionals. Diminished limits, increased deductibles or lack of any insurance are strong economic incentives for corporations to apply loss prevention techniques to the very process of corporate governance. "Loss prevention" is not a science, it is barely an art. Techniques are still developmental, unproven and, largely, unprovable. In other words, rarely can one demonstrate that a particular loss prevention effort actually prevented loss. Thus, loss prevention must be approached from the empirical basis that focusing upon the causes which have given rise to previous claims against officers and directors can eliminate future claims. The dollar savings

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128. 15 U.S.C. § 3901 (1986 Supp.). *See also* BUS. INS., Oct. 20, 1986, at 96-100 (full text of amendment).

129. Geisel, *Groups Mobilize to Use New Risk Retention Act*, BUS. INS., Oct. 20, 1986, at 1.

likely to result, however, can rarely be demonstrated for a particular corporation.

The initial step to developing a program of loss prevention is to identify the risks which a corporation should seek to avoid. In the corporate setting, many obvious potential risks are difficult to prevent. Mergers, acquisitions, "unfriendly" takeovers and stock offerings often result in litigation. Another type of claim against directors and officers is the suit for wrongful termination or employment discrimination by a disgruntled employee. Commercial transactions with clients or customers of the corporation are another common source of claims. Finally, actions by third parties against directors and officers under the Racketeer Influenced and Corrupt Organizations Act (RICO)[130] are becoming all too familiar.

To avoid lawsuits, corporate boards should adopt and implement explicit procedures designed to educate their directors and officers and, ultimately, avoid losses. The focus should be educational rather than punitive. For example, programs designed to inform corporate officers and directors about their legal responsibilities and, thus, their potential liabilities may, in the long run, prove more effective than any other single preventative step. Nevertheless, companies should not hesitate to take action against individuals who, by their conduct, expose the corporation to an increased risk of liability.

B. *Loss Awareness*

While it is impossible to identify all potential sources of liability, any organized loss prevention program must begin with such an analysis. A careful examination of all prior claims, as well as the potential litigation risks involved in the various aspects of a company's business dealings, should result in a reasonably clear picture of potential exposures. Counsel experienced in corporate litigation can be of great assistance. As company management becomes more aware of these risks, their actions will take into account the relative liability consequences. The focus should not be on all risks but only those likely to have significant financial impact.

The principal goal of the "loss awareness" component of loss prevention is the avoidance of an error or other misstep likely to result in a claim. As noted, programs designed to educate company management of their exposures may be an important factor in this

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130. 18 U.S.C. § 1961 (1982).

area. A peer review program, such as that adopted by many of the "Big Eight" accounting firms, might also be appropriate for certain corporations.[131] Of course, it is unlikely that companies competing in the same field would be comfortable with their competitors gaining a detailed knowledge of their inner workings. Nevertheless, companies which are not in direct competition may well benefit from such periodic, independent oversight.

C. *Loss Avoidance*

Assuming that an error has not been prevented in the first instance, the next goal in a successful loss prevention program should be the avoidance of an actual claim or lawsuit. For example, even where mistakes have occurred, many lawsuits can be avoided by prompt intervention. Many hospitals have implemented "patient relations" programs designed to minimize bad feelings in the wake of some form of medical error.[132] A patient who has been treated with respect and who is made to share in the decision-making process may not elect to sue even if an operation has not succeeded. Similarly, client or customer relations programs could deter litigation even in the face of a problem which, if left unattended, might otherwise result in a claim. Moreover, an important lesson lies in the fact that a significant percentage of lawsuits do not result in payments to the claimants.[133] In part, unproductive lawsuits are brought because of failures in communication, such as corporate actions taken in seeming disregard of minority shareholders. Often the appearance of providing notice and due process is more important than the reality.

D. *Loss Minimization*

As a final step, assuming a claim has occurred, a company must concern itself with avoidance of the ultimate loss by seeking to repair or otherwise mitigate the damages sustained by the claimant. Such procedures will need to be implemented on a case-by-case basis often with the assistance of counsel. Nevertheless, a prompt and objective

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131. Many professions have encouraged the use of peer review programs. Large accounting firms were among the first to take such measures, and their experience in implementing the programs, together with the nature of the profession, might make their approach particularly appropriate for corporations.

132. *See* Richards & Silvers, *Risk Management Theory: Reducing Liability in Corporate and Medical Environments*, 19 HOUSTON L. REV. 251, 269 n.65 (1982).

133. *See supra* note 2 and accompanying text.

analysis, taking into account the risks and benefits of early resolution, should at least lead to the development of a range of options to minimize any loss. Seasoned litigators recognize that hindsight often demonstrates the economic wisdom of early negotiation and compromise.

E. *Implementing Loss Prevention*

Loss prevention should be viewed as a nondelegable, internal corporate function. Although few hold themselves out as loss prevention experts, consultants are available who have useful expertise, such as lawyers and accountants. The ultimate responsibility, however, should be assigned within the corporation, although the designee will depend upon the size and nature of the entity. Large corporations which have personnel and insurance departments should consider a similar status for loss prevention (which may also be appropriately integrated into the insurance department). For smaller corporations, a committee or individual may be the appropriate designee.

The initial task should be an evaluation of existing loss prevention systems and designation of loss prevention needs. Such a review should take place with a view to both short-term and long-term factors. Implementation of systems and more elaborate record keeping are examples of the former; continuing education and review of ongoing corporate performance reflect the latter. These needs should then be prioritized and a program for implementation developed. Although looking to the programs of other corporations can be useful, differences in such elements as products, services, geography, shareholders, and financing require that the ultimate program be a personalized product of introspection and analysis.

F. *Monitoring Systems*

Any effective loss prevention program must be carefully monitored. General trends must be identified and, where appropriate, specific responses implemented to identify, avoid, and minimize losses. Any monitoring system should be designed to identify unusual events, or those determined to be outside the norm of the ordinary course of business. Such unusual events should be brought promptly to the attention of a person with sufficient authority to intervene at that point for the purpose of loss avoidance or minimization.

A company employing such a program should be conscious that it could create new risks by merely documenting incompetence without taking steps to eliminate the cause. In the health care field, many

states have begun taking firm measures to discipline or revoke the licenses of incompetent physicians.[134] Successful loss prevention entails eliminating the cause of losses as well as acting swiftly to minimize their impact.

In the corporate setting, enhanced record-keeping and precise documentation can greatly aid the foregoing process. Detailed board minutes and records of key events should be regularly reviewed with an eye towards the concept of loss prevention. Systems to enable a corporation to meet deadlines or otherwise enhance and maintain customer relations will also aid in this process.

V. CONCLUSION

Society in general has come to rely upon the relatively inexpensive availability of insurance as a means of risk protection. A consumer oriented society, where litigation has been characterized as a "national pastime,"[135] has made risk protection essential to the economic health, if not survival, of corporations large and small. The sudden and unexpected constriction of the insurance market, however, has created an awareness that risk protection must also include risk avoidance.

Although the present insurance crisis will eventually prove to be cyclical, the cycle will be longer than usual. The availability, price and limits of insurance in the future are not likely to return to previous levels. Since the problems are long-term, the solutions should be approached on that basis. Moreover, it should be remembered that insurance cycles are likely to recur. If there are lessons to be learned, they are that loss protection should include loss prevention, and that such a responsibility is for the corporations, not the insurance industry.

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134. *See* Brinkley, *State Medical Boards Disciplined Record Number of Doctors in '85*, N.Y. Times, Nov. 9, 1986, at 1, col. 1.

135. *See, e.g.*, Bickel v. Mackie, 447 F. Supp. 1376 (N.D. Iowa 1978); Ackerman v. Lagano, 172 N.J. Super. 468, 412 A.2d 1054 (Law Div. 1979).